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A Monetary Hope for Europe

The Euro and the Struggle for the Creation of a New Global Currency

Edited by
Max Guderzo and Andrea Bosco

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Preface

Andrea Bosco, Max Guderzo

This book opens a new series edited by the Jean Monnet European Centre of Excellence of the University of Florence, *Verso l'unificazione europea*. It is about the euro in a global perspective, and most chapters have been written by economists who met and discussed their diverse views at a multi-disciplinary conference organized by the Centre in May 2013. This Conference, entitled *The euro and the struggle for the creation of a new global currency: Problems and perspectives in the building of the political, financial and economic foundations of the European federal government*, owed much to Dr Matteo Gerlini's indefatigable cooperation with the activities of the Chair of History of International Relations and the "Machiavelli" Inter-University Centre for Cold War Studies (CIMA). The list of contributors also includes historians as well as scholars of European and international law. Their essays have been carefully revised on the basis and against the backdrop of an ongoing crisis of both the euro and the entire European project over recent years and months. They have been examined by a pool of colleagues at the University of Florence, among whom the editors would particularly like to thank Giuseppe Coco and Rossella Bardazzi who respectively wrote the introduction and the conclusions of the book, and Laura Sabani who together with Elisa Cencig added a new contribution as well as providing many useful comments on the chapters. Finally, the book was submitted to the usual peer-reviewing procedure organized by Firenze University Press. The editors would like to thank Fulvio Guatelli, editor-in-chief of the FUP, for his most helpful support through the stages of publication and the EACEA (Education, Audiovisual and Cultural Executive Agency) of the European Union for its cultural and financial contribution in the framework of the three-year project promoted by

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the Centre of Excellence between 2011 and 2014: «The EU and European unification: State of the art and perspectives»[1].

As a short preface to the very interesting data and interpretations offered in the chapters, the editors would like to start from a very simple but possibly controversial comment. In the history of monetary unions the euro represents a unique case, which cannot be assimilated to other past attempts to create single or common currencies among different States, or States which had independent political and economic institutions. Furthermore, they share the opinion that it is possible to single out three models of monetary union implemented since the introduction of currency as an instrument for exchange and transactions among individuals or groups of individuals. The first model is that of monetary unions achieved through the expansion of the political, military and economic influence of a hegemonic State on other States. The second regards monetary unions established through the cooperation of independent and sovereign States. The third concerns monetary unions achieved through the creation of federal political institutions by independent and sovereign States.

These models make it possible to identify the character and historical significance of a specific monetary union related to the creation and evolution of the political institutions which produced it. Being a fundamental attribute of sovereignty, the currency in fact represented a tool which introduced a limitation, permanent or provisional, of national sovereignties, generating a process of integration, permanent or provisional, among them. The shift of monetary unions from one model into another, or their dissolution, therefore depended on the character of the political institutions which generated them and on their duration. Since the introduction of currency as an instrument for exchange and transactions among individuals or groups of individuals, there have indeed never been monetary unions existing independently from the political institutions which had generated them.

The first model can include monetary unions based on the principle of empire, colonialism, or economic supremacy[2]. The idea of a common and widely accepted currency was first realized in the Aegean Sea during the mid-sixth century BC by three major trading powers: Aegina, Corinth and Athens. While with the stater (with the turtle as its symbol) Aegina created the first international currency, largely as a result of its control of the cop-

[1] More details on the Centre's history and activities may be found on its website, <http://www.unifi.it/cmpro-v-p-4085.html>.

[2] The historical data offered in this preface are taken from the interesting volume by P.L. Cottrell, G. Notaras, G. Tortella (eds.), *From the Athenian Tetradrachm to the Euro: Studies in European Monetary Integration*, Ashgate, Aldershot-Burlington (Vt.) 2007. Andrea Bosco has elaborated the three-model interpretation in line with the thought of Mario Albertini: philosopher, political leader and key figure in the European federalist movement in the last century.

per mines and its hegemonic political and economic role in the East Aegean Sea, Corinth then introduced its own stater (bearing the image of Pegasus) particularly in its colonies in the Ionian and Adriatic seas. Athens then replaced the stater with the tetradrachm, featuring the owl and using silver from Laurion. For two centuries the hegemony of Athens extended to the entire Aegean Sea: from the early fifth century BC (following the victories over the Persian navy at Salamina in 480 BC and Mycale in 479 BC) to the fourth century, despite its defeat in the Peloponnesian War. The Alexandrian tetradrachm replaced the Attican tetradrachm up to the third century BC, becoming the common currency of the Hellenistic world. Rome and Byzantium replaced the tetradrachm with various coinages – the denarius, the sestertius, the aureus and the dupondius – extending the area of the common currency to coincide with the borders of the Empire and neighbouring regions, with the Mediterranean as its heart.

Spain, in the age of Charles V and Philip II, introduced the silver peso and the gold escudo as the common currencies of an Empire with its centre in the Mediterranean. Maria Theresa's thaler – the currency of the Austrian Empire – created the larger Continental currency area after the fall of the Roman Empire. This was replaced by the 'continental system' of Napoleon I, manifestation of the French struggle for European hegemony which inevitably aroused British rivalry. However, the French attempt to conquer the sea by the power of the land lasted for six years only and collapsed after the Russian disaster. The florin was created through the German monetary unification of 1837 between six German States: Bavaria, Baden, Württemberg, Hesse, Nassau and Frankfurt. This was extended to the rest of the country through three wars by Bismarck and then to Austria in the period from 1857 to 1866. The Piedmont lira spread to the rest of Italy in 1861 as a consequence of the completion of Italian unification.

The second model can be applied to monetary unions established through the cooperation of independent and sovereign States as a result of the temporary convergence of their 'reason of State', namely, their vital national and strategic interests. The nineteenth century was characterized by the Anglo-French duopoly of financial power, and within this context the Latin monetary union emerged, which included France, Italy, Switzerland, Belgium and Greece and lasted from 1865 to 1914. It was based on bimetallism: namely on gold and on silver, which was about 15 times less valuable than gold. National and international monetary problems during most of the nineteenth century were the consequence of the oscillation of the gold/silver market prices sparked by waves of new mining discoveries in new countries such as the United States, Australia, and South Africa. In fact, during the nineteenth century France and Great Britain adopted opposing monetary policies, even though their central banks cooperated to maintain the highest possible degree of monetary stability within their own spheres of influence. While from 1717 Great Britain let the price of silver float freely by choosing a mono-metallic gold standard, France decided in 1785 to fix the parity between gold and silver and managed to hold to this up to the outbreak of World War I. During the nineteenth century France and Great Britain were the two main lending States, marking the first time in history when the main lending States were also great powers.

The rise to the rank of world powers of Germany, the United States, Italy, Russia, the Habsburg Empire and Japan, however, marked the crisis and the end of the international financial system based on the Anglo-French alliance with the Channel as the centre of gravity of world power. The Latin monetary union was put to test by the divergences in Franco-Italian relations over colonial policies in North Africa, by the German victory over France in 1871, by the decline of silver (and bimetallism) as a base for currency and by the creation of the German Gold Standard Reserve, which put an end to bimetallism. The Scandinavian monetary union – inaugurated in 1872, following the French defeat – was the most successful of all European monetary unions. It established the gold crown and, in 1885, a Bank Clearing System which guaranteed monetary and economic stability to countries such as Denmark, Norway and Sweden, which were, nevertheless, largely peripheral to the centre of world power politics.

The third model is represented by the monetary union of the United States of America, established since 1789, with the exclusive competence of Congress on monetary policy. However, it was not until the 1930s that all the American States became component parts of a single 'optimal currency area'. The principle of federalism gave precedence to political rather than economic reasons for integration between independent and sovereign States. Only by pooling of monetary and fiscal sovereignty within a new supranational institution, responsible before Parliament, could monetary union be permanent or indissolubly bound to the existence of the federal government. The first example of the application of federal government outside North America was provided by the Swiss Confederation, which came into existence in 1848, merging 22 sovereign Cantons. Germany provided another example for the application of the federal system. However, the existence of a largely preponderant State within it – Prussia – produced a *de facto* shift of the federal into the unitary principle. Born federal, the German Constitution was progressively transformed into the most centralized and despotic system of government in modern Continental Europe.

On the basis of this very brief historical survey of past monetary unions in line with the three models described, it is possible to propose a number of conclusions as to their relation with the euro experiment analysed in this book.

First, it emerges that small States outside monetary unions have limited policy autonomy because of the pressure exercised on them by capital flows in particular, and economic globalization in general. Monetary unions represent centres of gravity, attracting an increasing number of States into their orbit for as long as they exist. The historical trend of successful monetary unions is therefore to expand their area and to enter into conflict with other monetary unions, unless there is a convergence of global interests.

Second, regional monetary unions can be created and work successfully for a limited period only within a stable political, economic, military and financial system. If during the nineteenth century this backdrop was provided by the British Empire, during the twentieth it was provided by the Atlantic union policy, which since 1941 – with the signing of the Atlantic Charter – created a new centre of world gravity in the North Atlantic. The Bretton Woods agreements, based on the dollar gold exchange, created an international monetary system which since 1949 guaranteed European reconstruction, anti-inflationary policies, price stability and full employment. The crisis of the sterling gold exchange – consequence of the crisis of the British Empire – had triggered the long period of international financial and economic instability which was a major cause of the two world wars. The crisis of the Bretton Woods system, followed by Nixon's unilateral decision to revert the dollar convertibility into gold, did not produce a major international crisis because of the process of European monetary union, which not by chance began in the aftermath of the crisis of the dollar as a global reserve currency. This crisis became manifest when the reserves of American gold began to markedly diminish and capital controls were progressively lifted, highlighting the incompatibility of the dollar retaining a link to gold and remaining at the same time an instrument of national and international policy-making.

Today the new economic and financial centre of gravity has shifted from the North Atlantic to the Pacific, without however producing a new 'Bretton Woods', since China has an autocratic government, Japan is a declining economic power and India is not yet a world power. The shifting of the world's economic centre of gravity has not therefore been accompanied by the creation of a new political organization to replace Atlantic institutions. Today the world is experiencing a split between economic-financial and political leadership. This is one of the main sources of the current international instability. The completion of the process of European monetary unification, and the parallel creation of a single Atlantic common market on the model of the European experiment, could bring economic-monetary power back to the North Atlantic, or to the Atlantic as a whole, if Brazil, Argentina and South Africa were included in the system.

Third, the creation of the euro was made possible by the stability provided by the 'Atlantic system'. The euro today has a predominantly regional dimension, since it is the currency of an area including some half-million European citizens. It embodies the successful attempt to stabilize international finance by stabilizing the European region in the aftermath of the crisis of the Bretton Woods system. Today we are also experiencing the possible transition of the euro from being merely regional into a new global currency, capable of joining the dollar as international reserve currency, and therefore also able to promote the creation of a new financial and economic settlement, expression of a specific dislocation of world power.

Finally, it could be said that the completion of the process of European monetary and economic unification is no longer merely one of many problems, but rather one of the most pressing and important of our time. The ultimate success or failure of the European experiment depends on the solution to this problem. The fundamental reason for the existence of the European Union is not the defence of a specific cultural, racial or religious identity, but the creation of a specific method of resolving conflicts among States by peaceful and constitutional means. The first Community institutions were not imagined and created 65 years ago simply to establish a free-trade area and promote economic development among its members. They were conceived as the first step in a political process which, through the pooling of certain vital governmental functions such as economy and currency, aimed to achieve a federation, not a league of nations, establishing economic stability as a fundamental condition for political stability. The experience of the attempted monetary unions of the past shows that the only ones which did not fail were those generated by a federal union, as in the American and Swiss examples, or those which generated a federal union, as in the example of Germany.

It appears therefore plausible to support the thesis – and the chapters of this volume provide some evidence for this, or at least very interesting material for thought – that unless the euro becomes the expression of the financial institutions of a federal government, responsible to a democratically accountable Parliament, it will prove to be reversible. And with it, the whole European experiment will be at risk, with the inevitable consequence for Europe of falling back into its political division into conflicting groups of States. The choice is therefore, as it has always been, between reaching a union through the pooling of sovereignty or through its exercise and projection in terms of old-fashioned and short-sighted power politics.

Introduction

Giuseppe Coco

Faced with the task of writing an introduction to a book on the euro eight years ago, before the financial crisis, I am sure that a fellow economist would have struggled in the attempt to demonstrate that such a discussion could contribute anything new. A big wave of studies in the decade before the run-up to the introduction of the euro discussed and dissected in detail the benefits and drawbacks of the common currency, in theory and in the light of the existing evidence. There were some solid results and it seemed that the issue was more or less resolved. Although the picture of the possible effects of the euro has not changed, we are now in a better position to assess which are dominant. The euro project has revealed some not entirely unpredicted weaknesses and a reassessment is necessary if it is to survive a not unexpected global financial crisis. It seems now that the euro, as it stands, may be one of the reasons for the prolonged stagnation in the euro area, as opposed to the relative recovery of the rest of the developed world, and could even be the cause of another wave of financial instability in the future. Therefore the project is at a crucial crossroads: reform or die.

Hence in a certain sense I am in a better position than my hypothetical fellow economist. However, if the usefulness of a book on the euro is a self-evident truth today, I am convinced that this volume effectively targets some of the crucial issues for the survival of the euro and European integration at large. Similarly I feel that an integrated approach, in which economists, political scientists, lawyers, sociologists and international relations experts work as a team, is absolutely essential to survival. This book embodies an attempt to address this task.

Some years ago conventional wisdom on the euro seemed fairly cut and dried. The euro would bring some obvious and direct benefits in terms of reduced transaction costs and some indirect benefits in terms of further in-

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tegration. Insofar as free exchange on a level playing field allows better resource allocation, it would also increase aggregate GDP. A fixed exchange rate eliminates an important risk in cross-border transactions and therefore makes economic integration far easier, in particular where long-term relationships and investments are involved. However, the elimination of the exchange rate and a single monetary policy for the whole area also implies relinquishing specific policy tools for addressing the different needs of different countries. The theory therefore went on to state that if the monetary policy necessary (i.e. optimal) for the different European countries were sufficiently similar, then the euro would certainly bring net benefits. Otherwise it wouldn't. However, the evidence on this point was somewhat mixed. Although many believed the degree of homogeneity of the euro area countries was not sufficient, others were convinced that further integration would bring forth the necessary degree of similitude. Consequently the case for the euro on purely economic terms was far from settled when the euro came into force in 2001. And the case for the euro area being an optimal currency area is still rather weak today (see Croci Angelini and Farina).

Indeed, some of the contributions in this book confirm the opinion that, though there may be long-term economic benefits to the euro, these could be substantially offset by problems stemming from suboptimal monetary policy and the lack of a mechanism for adjusting imbalances that may over time generate differential competiveness among participating countries.

An additional problem is that monetary integration is a much more complicated issue, involving not only real markets but also financial markets and, importantly, governments. As was immediately noted, the public debt of a country is necessarily tied to its currency and in the long run to inflation. Waiving monetary sovereignty necessarily involves a cost in a perfect world, but could deliver a benefit in a world where politicians find it hard to credibly commit to public debt and inflation stability. We have seen this in Italy when, between 2001 and 2008, the interest rate on the Italian public debt and the spread relative to the safest investments decreased dramatically, making it easier in theory to pursue virtuous budget policies. Obviously, the realization of such benefits is far from automatic. They depend on the ability of the political (and economic) system to take advantage of the opportunity. If the opportunity is missed, one is left with the cost of reduced policy instruments.

In the end it is clear that, far from delivering safe gains to every country, the euro was bound to deliver a much more complicated set of effects to the various countries and possibly, also depending on the behaviour of governments, a considerable redistribution of wealth.

To add to the complications, it was clear from the beginning that even taking the benchmark Ricardian model of free exchange at face value in its prediction of benefits for all countries involved in greater integration in the long run, integration is bound to generate some groups of losers within countries. Needless to say, we can expect the losers to be more vocal than the winners in each country.

So finally we are left with a complicated set of predicted effects that can vary greatly between countries, social groups and classes, and depend significantly on the behaviour of the political system in each country. So how is it that the decision to proceed with the euro met with such little resistance in Member States that adhered to the common currency? This question clearly cannot be answered on purely economic grounds. One has to bring the political variables into the picture to understand the real benefits of the further integration that the common currency was to bring with it. The decision to proceed with monetary integration was a political one. This is clearly established in several essays of the book, in particular that by Mauro Campus providing a convincing reconstruction of the process leading up to the EMU and in Lacina's contribution. Consequently, the principal benefits of integration must also be sought in the political sphere, or at times in the political-economic package. The simplest example illustrating this last point is the (failed) emergence of the euro as a reserve currency challenging the secular dominance of the dollar and the rising role of the renminbi (see here the two essays by Andreosso-O'Callaghan and Calvo Hornero). Other instances in which the international-political role of the euro is put to the test are discussed in Wouters and Ramopoulos (on the relationship with and within the IMF) and Fink, Rainer and Haiss (on the use of the euro in countries outside the euro area but within its political area of influence). All these examples demonstrate that, without a solid and credible political plan, a supranational currency is destined to remain at best a regional currency. The degree of stability of the euro is currently being tested by the markets mostly on the basis of the political decisions periodically made by the Council. However, this is not a sufficiently solid basis to make this currency a credible long-term store of value.

If, on the whole, the main benefit of monetary integration is political, then the necessary consequence is that further integration is absolutely necessary. We are now experiencing the limits of the euro experiment as it is. Coordination of economic policies through enforcement of the Stability Pact will sometime soon reach the limit and is already increasingly perceived in several countries, rightly or wrongly, as a violation of national sovereignty. With public debt rising across Europe and growth in the low digits, the risk of further crises is still present in the medium term. The only viable option for avoiding this possibility is to pursue an agenda of further integration. One of the most important and interesting essays in this volume describes the main area in which integration has proceeded apace following the crisis: the Banking Union (see the detailed account by Breuss).

Further integration is therefore necessary, but when it comes to the required speed of integration and the areas where integration is called for, it seems that there is some disagreement among scholars. Further reforms that enhance economic integration are under way but it is doubtful whether they can achieve financial stability. The two main contributions on this issue in the book (that already mentioned by Breuss and the essay by Keuschnigg and Weyerstrass) both – at least in my reading – take a minimalist view. Continued reform should deliver proper, level playing field markets leaving the fiscal responsibilities for adjustments to national governments, under the appropriate supervision by EU institutions. I have a different opinion.

Although it is difficult to overestimate the importance of the Banking Union process, we must be aware that it is not likely to be sufficient, and it may actually backfire without other initiatives to stabilize public debts. Furthermore, in the long run euro-building cannot be safe and credible without a further strengthening of integration, not only in an economic sense. In 100 years' time the euro experiment will probably be judged on the basis of such strengthening. If it paves the way to gradual political integration, even purely from necessity, then it could survive and its role might possibly be appreciated by economic historians and social scientists as the most spectacularly successful experiment of government in history. Otherwise it will be archived as one the longest-lived attempts at currency unions, and most likely also one of those that caused most havoc when it collapsed.

One particularly difficult issue is the optimal degree of fiscal independence of Member States. In a monetary union each country waives the possibility of monetization of its public debt. In the right perspective this strategy could be an advantage for any country. But in certain circumstances, both exogenous such as a financial crisis and endogenous such as a reckless government, it may turn out to be a nightmare. The Stability and Growth Pact works only to a limited degree, as recent years and the Greece shambles have demonstrated. Again, externally imposed austerity can be enforced up to a point, if national fiscal sovereignty remains intact, and in the long run it generates a resentment that could backfire dramatically on the political system. My opinion is that at some point in the future – I hope as distant as possible – we (the euro countries) will be required to make an important and enforced choice between relinquishing national fiscal sovereignty, at least partially, and relinquishing monetary integration. We need to be prepared for that moment.

Whatever idea one has about the optimal further integration, academics and the ruling class are now being called to make major efforts to devise politically viable forms of integration and the institutional arrangements most appropriate to lead to those changes. That is why we need different types of social scientists to collaborate on this task. As academics, we must start analysing political and economic processes in an integrated manner (an interesting example in this book is the contribution by Cencig and Sabani). For too long the euro has been considered a pure form of economic integration, without political consequences. The truth is that there was no compelling economic case for going ahead with the euro from the start, unless there was a political project for further integration behind it. Moreover there is not a single example in the past of a monetary union working without a real political power backing it. Money is trust. It only has value as long as the backing power is stable. In the long run, the issuer cannot be a club of States that may or may not decide to stay together in the future, depending on short-term convenience. This is particularly true today since short-term political opportunism can easily stir public opinion away from the real long-term interests of the European people.

We now see that the euro has not made that political project more likely to happen, due to prolonged instability and lack of growth in the aftermath of the financial crisis. A political initiative is required, but it must be consistent with the political reality of an ever-growing dissatisfaction with the Monetary Union in Member States. This book is a starting point, although in the future I hope that an increasingly large body of work will be engaged in actively proposing further possibilities for integration and institutional innovation at EU level.

PART I

The Process Towards a European Economic and Monetary Union

Designing a Non-National Currency: The European Monetary Union from the European Monetary System to the Euro

Mauro Campus

1. Introduction

The Eurozone crisis strongly challenges the integrity and the future of the European Union (EU). The International Institutions programme asked experts to assess the immediate and long-term implications of this crisis for the continent's political and economic future (De Grauwe 2010; Streeck 2015). It is nota coincidence that, eight years after the breakout of the Great Recession, the 19 Eurozone countries are still the most exposed to its effects on the real economy, whereas almost all other areas of the developed world, the US first, have recovered more easily and quickly than the 'old continent'. The crisis has also spread geographically, with its worst consequences becoming visible in the southern countries of Europe rather than in the financial centres of the world where it originated (Helleiner 2014).

In order to understand the reasons why the euro has set up challenges to the very existence of the EU, it is crucial to analyse the historical, political and economic reasons for its creation. This is the aim of this essay, which synthetizes the European political debate from the rise of the European Monetary System to the signing of the Maastricht Treaty (Eichengreen 1993, 2000, 2011; Apel 1998). It is in the European Monetary System (EMS) and in the Maastricht Treaty that the main pillars of the current economic and – in more than one sense – political structure of the EU, and of the euro area in particular, are to be sought (Gros, Thygesen 1992; Judt 2011).

2. The Bretton Woods collapse and the rise of the European Monetary System

The creation of the EMS is considered one of the milestones of post-war Western European history. Countless studies stress that it was an exam-

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ple of how European elites coped with global economic change (Mourlon-Druol 2012; James 2012; de Saint Périer 2013). The advent of a floating exchange rate after the Bretton Woods system collapsed in August 1971 (Strange 1986; Feldstein 1988; Helleiner 1994; Basosi 2006) was harmful for Western European economies and the EMS constituted a European response (Padoa-Schioppa 2004). Indeed, it represented the first serious attempt to reintroduce a semi-fixed exchange rate system on a European basis (Giavazzi *et al.* 1988). It is even more important that the European response was to have a strong influence on the economic and social policies of many participating European countries from 1979 onwards. The EMS would be an external constraint – lauded or criticized – for the domestic economic policy choices of many European governments. Moreover, the importance of the EMS was represented by numerous European policymakers as the first necessary step on the road to an Economic and Monetary Union (EMU).

The European Currency Unity (ECU), the argument goes, was the forerunner of the euro. Though both these assertions are debatable, they do hint at one of Western Europe's perennial problems: the need to stabilize monetary relations in the richest world market (Marè, Sarcinelli 1998: ch. 5). From the nineteenth-century Latin Monetary Union to the present day euro, organizing currency fluctuations within Europe has remained a central issue for European policymakers. But the EMS was more than just an exchange rate system. The inception of the EMS was part of a wider trend towards the tentative affirmation of the European Economic Community (EEC) as an international actor amidst the profound economic, political, institutional and social transformations of the 1970s (Chassaigne 2012).

The EEC, created in 1957, had specific competences, multiple levels of governance and a varying record of successes and failures. But in the course of the 1960s and 1970s it witnessed a steady enlargement of its sphere of influence (Hirschman 1990: chs. 2-3). The EEC became a key international trade actor, set up diplomatic relations and concluded a trade agreement with the People's Republic of China. The European Political Cooperation (EPC) process, created in 1970, attempted to give a single voice to the EEC in foreign policy, with many failures but one important success at the Conference on Security and Cooperation in Europe (CSCE; see Möckli 2009).

The late 20th century debate about an institutionalization of European monetary arrangements continually evolved into a wider context of discussions on the global monetary system and its problems. Debates about new institutional mechanisms (such as a basket currency) that took place on global level were also replicated with respect to European affairs. The first discussions about a monetary union occurred in the late 1960s and culminated in the Werner Plan as a way of managing a European response to the crisis of the dollar and the ensuing breakdown of the fixed exchange rate system that had been devised in 1944 at Bretton Woods (Louis 1993; Gavin

2004). The next two surges of European Monetary institutionalization followed crises in the international system.

The European Monetary System ought to be considered as the end of a period in which part of Europe opposed the hegemony of the United States in the monetary field (de Cecco 1988). During the 'decade of the four shocks', when Germany was almost alone in urging a bulwark of monetary stability against double-digit inflation in the United States, France and Britain devalued their currencies under the pressure of quite different circumstances. Conversely, a few months later (October 1969) Germany, albeit sensitive to the American cycle, under the pressure of constant surplus was forced to a revaluation of the mark – something which happened throughout the decade – when the D-mark value grew steadily against the dollar and other European currencies (Sargent 2015; Kloten 1980).

This was the time when the decisions in the eighth paragraph of the Hague Agreement (1969) were adopted and swiftly extended by the goals of the Werner Report (1970), which provided for the establishment of a European monetary system within the decade (Draghi 1978). The formula was correct but still unable to deal constructively with the collapse of the fixed exchange rate system. Nevertheless, these decisions began to lay the foundations of the project for Community economic and monetary union (Guasconi 2004). From the very beginning of the discussion about a European Monetary Union in the 1960s it had been clear to many participants that some support mechanism for regional funds or short-term lending facilities would be required to move along the new monetary mechanism. And such transfers would be likely to involve governments if there were to be more than short-term revolving credits. The 1969 Barre Report, which proposed greater economic coordination, brought new impetus and the Economic and Monetary Union became a formal goal at the Hague summit in 1969. European leaders set up a High Level Group led by the Prime Minister of Luxembourg, Pierre Werner, to report on how the EMU could be achieved by 1980.

In the 1970s the Werner Plan (a major proposal of monetary union) and a new institution, the European Monetary Cooperation Fund (EMCF) initially foreseen as a potential federal reserve system for Europe, were supposed to be at the heart of monetary reform. Some countries wanted such a Fund to make major transfers between members; others (notably Germany) were extremely reluctant. The Werner Group submitted its final report in October 1970, setting out a three-stage process to achieve the EMU within a ten-year period. The final objective would be the irreversible convertibility of currencies, the free movement of capital and the permanent locking of exchange rates – or possibly a single currency. To achieve this, the report called for closer economic policy coordination, with interest rates and management of reserves decided at Community level as well as agreed frameworks for national budgetary policies.

It is common opinion that the 1970s were a decade of failure and unsolved problems. Growth collapsed and inflation soared. Budgets came under strain. These problems also generated vigorous institutional activity in search for solutions. Judging by results, the 1970s marked a low point of international cooperation. However, the failures were so apparent that a massive number of schemes and plans on monetary and financial issues were formulated, at both global and European level.

It is appropriate that the major symbol of the troubled era of European monetary cooperation in the 1970s became the exchange rate system called 'Snake'. Created by EEC members to narrow the fluctuation margins between their currencies, thereby implementing one of the measures listed in the first step of the Werner Plan, the System came into force on 24 April 1972 (Ingram 1973). The four EEC candidates took part in the Snake negotiations and joined the scheme. Austria, Spain, Switzerland and Sweden sooner or later expressed an interest in it, partly because of their strong commercial relationship with this monetary zone. Sweden was the only country to formally request an association with the exchange rate system, while the other three maintained a *de facto* stable exchange rate relationship with the Snake. The only limitation for the non-EEC members was that they could not benefit from EEC monetary support mechanisms. Their association took the form of bilateral agreements with each and every central bank of the Snake.

A ceiling (2.35%) was placed on fluctuations between currencies by intervening on the currency market. For a short period the Snake undulated in a sort of tunnel. Indeed, between 1972 and generalized floating in 1973, the Snake currencies respected established bands of fluctuation *vis-à-vis* the dollar (4.5%). Over time, however, the overall Snake system became a D-mark zone since the British pound, the French franc and the Italian lira rapidly abandoned it. The overall implementation of the Werner Plan soon ran into difficulties mainly because it implicitly relied on a functioning Bretton Woods system – which was collapsing at precisely the time the Plan's first stage was being applied. The Werner Plan, its goal and its method would, however, continue to influence European monetary cooperation in the second half of the 1970s (Draghi 1978).

In 1978 the European monetary regime was rebuilt, but the Committee of Governors (CoG) did not play a central role in the reform. The major initiative came from politics and in particular from the French President, Valéry Giscard d'Estaing and the German Chancellor, Helmut Schmidt. These high-level debates were charged with lofty geopolitical ideas and the new monetary arrangements were frequently seen as a challenge to the preponderant role of the dollar in the international monetary system. European policymakers were sceptical or hostile. The CoG's involvement was largely confined to an elaboration of the so-called Belgian compromise, which reconciled divergent French and German conceptions on how to institutionalize fixed-exchange rate agreements. In the end, however, despite an enormous amount of political energy expended on the project, not much actually changed. The agreement on a new basket currency could have been a basis for monetary unification but in practice it was not. There was no EMF and the outcome was difficult to distinguish from a strengthened or revitalized Snake (James 2012).

The experience of 1978 showed that reform could not come from a political initiative alone, however great the eloquence and passion of the political leaders. By 1978 a number of different plans for European monetary reform were in the air, or at least in the filing cabinets: the Fourcade proposals, the Duisemberg Plan, the Van Ypersele Plan, the All Saints' Day Manifesto, proposing specific rules of devaluation, the initiatives of Belgian Finance Minister Gaston Jeens to increase financial support in the community and reinforce budgetary and monetary discipline and coordination or the Times Group scheme. Europe was under great economic stress with wildly varying rates of inflation and sharp dollar depreciation against the D-mark that exacerbated the strains of the other European currencies (Eichengreen 2011). The Snake was confined to a very small group of countries and had basically become a D-mark zone while the other large EEC currencies, the franc, the pound and the lira, floated. There were simply both too many ideas and too many problems (Ludlow 1982).

The eventual outcome of the intensive negotiations of 1978 – the European Monetary System (EMS) – is often regarded as a transformative step on a progressive path to monetary integration. But was it so? Or was it nothing more than an elegant repackaging of the Snake arrangements? In 1978 a fundamental lateralization of monetary discussion occurred. The Franco-German relationship was always at the core of debate about reshaping the monetary order, but in 1978 a series of personal initiatives was launched by Schmidt and Giscard d'Estaing. One outcome was that the role of the Bundesbank, as a possible obstacle to the new initiatives, assumed new importance since it appeared to possess a right of veto. Schmidt often seemed to regard the German Central Bank as his primary adversary.

The new proposal appeared to have political origins in particular within the European Commission. The President, Roy Jenkins, tried to reignite the currency discussion through a grand and visionary proposal launched in Florence at the European University Institute in October 1977 (Campbell 2014). In December, at its Brussels meeting, the European Council reaffirmed its attachment to the objective of economic and monetary union. At the same time it admitted that, although such union was an integral part of the process leading to a European Union, it was clear that since 1972 this great endeavour had been stagnating.

The rapid 'death' of the Snake did not diminish interest in trying to create an area of currency stability. After particularly swift negotiations led by the major European central bankers, the EMS was launched in March 1979 with the participation of all Member States' currencies except for the British pound, which joined later in 1990 but remained only for two years. It came as a reaction to the large fluctuations of the dollar and was stimulated by the belief of policymakers that intra-European exchange rate uncertainty was detrimental to trade and investment in Europe. The primary purpose of the founders of the EMS was therefore to create a zone of relative exchange rate stability which, if successful, could contribute to better prospects for growth of income and trade in Europe. Moreover, it was hoped that the construction of the EMS would facilitate the convergence of EEC economies. By doing so, it would create the necessary conditions for further economic and political integration in Western Europe.

The conceptual core of the European Monetary System (EMS) was the result of a Franco-German project the main lines of which were presented at the Copenhagen European Council on 7-8 April 1978 by Giscard d'Estaing and Schmidt. The plan aimed to reconcile France's ambition for a more balanced system in which her continental leadership could be reaffirmed with Germany's austerity, which had earned the D-mark control over European currency markets. The project involved the creation of an international monetary system formally independent of the dollar and the international financial institutions, based on the pooling of currency reserves (within two years after the launch of the system) and the creation of a fluctuation band of ± 2.5% periodically corrected by the central parity realignment mechanisms needed to ensure stability. The compromise at the roots of the system had to overcome the resistance of both the Governor of the Bundesbank, Otmar Emminger, and the German economic establishment, which believed the D-mark might replace the dollar as the key currency of European capitalism (Watt 1979). In 1978, all the political and economic conditions for this transition existed, but the solution would not meet the needs of such an economically integrated and complementary productive environment as the Community had become. The situation was even more complex because of the lack of confidence in the resilience of the new system and the concerns of the German Central Bank about inflation risks due to the fixed exchange rate.

Ignoring German misgivings, the plan (Bremen Annex) was presented to the European Council on 7 July, negotiated during the following six months and launched on 5 December. Three years earlier Bonn would have never dared to embark on anything so independent of the United States. A set of variables had played a role in this change of attitude towards the agreement. In 1978 the international monetary system was still centred on the dollar, but the Carter administration claimed that the US currency had formed listing markets unrelated to Washington's policies. This was perceived as yet another signal of the abdication of American leadership in Western Europe and helped undermine Schmidt's confidence in Carter and US foreign policy in general. In addition, Carter repeatedly spoke in favour of the creation of a European Monetary System.

Italy showed immediate interest in the initiative and promoted it at the Monetary Committee: the establishment of a reserve fund, i.e. a more flexible system than the Snake, did not preclude later expansion to members in difficulty (the United Kingdom), symmetry in the adjustment process and intervention in favour of the less developed areas of the Community. However, even if entry to the EMS soon came to be perceived as the best means to overcome the crisis, the road from Bremen to Brussels and Rome proved to be particularly tortuous. The experiment of joint float was the most significant international economic turning-point for Italy since the accession to the Common Market (de Cecco 1988).

The creation of the EMS in 1979 was a conscious response to the rapid decline of the dollar in 1978-79, the perceived crisis in American leadership under Jimmy Carter and the consequent search for a new international mechanism to replace the dollar standard. The core of the new approach was originally meant to be a basket currency as an account unit – the European Currency Unit (ECU) – which conveniently echoed the name of an ancient French coin. A new European currency would possibly be a replacement for the dollar, take some of the strains out of the international monetary system and redesign or reform the IMF's artificial currency, the Special Drawing Right. In the 1980s the dollar again caused worldwide chaos as its value soared up to 1985 and then declined rapidly. Europeans felt vulnerable because they did not control an international reserve currency that could stand up to the dollar. Europe's response to that international uncertainty began with the report to the Delors Committee in 1989 and continued through the negotiations and approval of the Maastricht Treaty up to the legal realization of the euro in 1999.

The establishment of the physical currency had its origins in an attempt to devise a mechanism that could generate a more stable global exchange rate regime. The critical policy innovators, in particular French Finance Minister Eduard Balladur, started to advocate its realization at European level also to address the 'German question'. By the 1960s the Federal Republic had emerged as the strongest European economy, with a dynamism built on a powerful export performance. German current account surpluses, driven primarily by trade surpluses, which appeared briefly in the 1950s, were corrected after a currency revaluation in 1961 but emerged again in the late 1960s, in the late 1970s, even more powerfully in the late 1980s, as capital movements were liberalized, and again in the 2000s. They had just disappeared in the 1990s, when the costs of German unification pushed the German external account into deficit, and Germany's relations with its European partners became more harmonious in consequence. The reform proposals that led to initiatives for European integration in 1970, in 1978, and again after 1988, were all conceived as means of addressing imbalances between European States. These dates were also moments of crisis in the global system. The most radical approach to Europe's problem was monetary union. This had the intrinsic appeal of apparently making current account imbalances vanish, as well as providing a mechanism for non-Germans to constrain or limit the Bundesbank.

The European Monetary System was built on the concept of stable but adjustable exchange rates defined in relation to the newly created ECU, based on a weighted average of EMS currencies. Within the EMS, currency fluctuations were controlled through the Exchange Rate Mechanism (ERM) and kept within ±2.25% of the central rates, with the exception of the Italian lira, the Spanish peseta, the Portuguese escudo and the pound sterling, which were allowed to fluctuate by ±6%. In August 1993, these bands were widened to 15% in order to counter speculative pressures, but by 1996 all currencies had moved back to their original fluctuation margins. The system included an intervention mechanism and a preventive tool: once the exchange rate of a currency reached 75% of the maximum authorized fluctuation margin, the currency was considered as 'divergent' and the country had to take remedial action through interest rates and fiscal policy adjustments. In the event of the maximum fluctuation margin being reached, central banks had to intervene by buying or selling the currency to avoid the margin being exceeded.

The EMS was a radical new departure because exchange rates could only be changed by mutual agreement between participating Member States and the European Commission, which constituted an unprecedented pooling of monetary sovereignty. In the first few years many currency realignments occurred, but by the time of the negotiations on the Maastricht Treaty in 1990-1991, the EMS had proved to be a success: short-term volatility of exchange rates between European Community currencies was substantially reduced, thanks to a wise mix of converging inflation rates and interest rate management targeting the exchange rate. This success created an encouraging backdrop to the discussions on the EMU, as did the valuable experience in the joint management of exchange rates acquired by the Community's central banks.

The case for the EMU emerged from the need to complete the single market, the programme adopted in 1985 for removing all remaining barriers to the free movement of goods, services, people and capital. It was clear that the full benefits of the internal market would be difficult to achieve with the relatively high business costs created by the existence of several currencies and unstable exchange rates. In addition, some economists and central bankers took the view that national monetary autonomy was inconsistent with the Community's objectives of free trade, free capital movements and fixed exchange rates. For most of them this view was later confirmed by the turmoil which hit the ERM in 1992-93, causing the withdrawal of the Italian lira and the pound sterling, and the widening of the fluctuation bands to 15%.

3. The Delors Plan and the Economic and Monetary Union

Although at the beginning of the 1980s the EMS turned out to be successful (Giavazzi *et al.* 1988), lowering the inflation rate and reducing exchange-rate stability, by the end of the decade the growth rates of its members were performing very poorly basically due to the 'antigrowth bias' of the system. Over these ten years the entire system had been *de facto* dominated by German preferences, since in effect the D-mark became an anchor currency asymmetrically influencing the policies of the other Member States. This asymmetry was firstly addressed by France in the 1987 Basle-Nyborg agreement and would eventually result in the proposal of a monetary union in which France would have regained parity *vis-à-vis* her 'rival' (Gardner, Perraudin 1993). The proposal was consequently supported by an influential report by the Italian economist Tommaso Padoa-Schioppa (1987), one of the leading figures behind European monetary cooperation, who endorsed the establishment of a monetary union, pointing out that «capital mobility and exchange rate fixity together leave no room for an independent (national) monetary policy».

Just as Schmidt and Giscard had been crucial to the establishment of the EMS, so Helmut Kohl and François Mitterrand were the key players in the EMU and the Maastricht compromise. However, the main novelty was certainly the election of the French socialist Jacques Delors as President of the Commission from 1985 to 1994. He was destined to change the role of this body, making it the strongest engine of a deeper European integration. In June 1988, following Mitterrand's victory at the French Presidential elections, at the Hanover Summit of the European Council, Kohl proposed the establishment of a committee mainly composed of the governors of the European central banks, which would establish the basis for the EMU. Delors was a natural choice to chair the committee, in which he participated also as commissioner responsible for monetary policy, together with another member of the EC, twelve governors and three independent experts. Delors proved to be an exceptional diplomat, managing to keep on board many different visions about the common economic and monetary policy, and eventually delivering his report in April 1989.

Although Delors was not really satisfied with the report, due to the lack of a direct call for a single currency, the document paved the way to the provisions of the Maastricht Treaty a couple of years later: the EMU had to be approached through a three-stage process in which liberalization of capital movements and macroeconomic cooperation among Member States was the first step, the establishment of a European System of Central Banks the second step, and the progressive direction of national economic and financial policies by EC authorities the final step.

From an economic and historical perspective, the new EMU had a major impact. It reinforced the Franco-German axis and personal relations between Mitterrand and Kohl and opened the definitive rift between Delors and the intransigent UK Prime Minister, Margaret Thatcher, who saw in him the personification of 'evil', essentially due to his political allegiance and strongly pro-federal and pro-European attitudes. Thatcher was opposed not only to Delors for being the main advocate of the EMU, but even more to the Governor of the Bank of England, who signed the report and the Governor of the Bundesbank, Karl Otto Pöhl, one of her strongest allies against the communitarization of monetary policy. Her intransigence compromised relations with her Foreign and Finance Ministers and was eventually to drive her out of office.

The international context in which all this was happening is crucial: the collapse of the Berlin wall in November 1989 played a decisive role in speeding up the achievement of the EMU, once again with the key cooperation of the French President and the German Chancellor. A unified Germany would signify a total readjustment of the European balance at one of the most delicate moments of European integration. The two processes were intrinsically intertwined since, as recalled by David Marsh (2009: 133), «if unification had not happened, it is highly unlikely that France would have been able to persuade Kohl to agree the EMU timetable to replace the D-mark by the euro». Establishing control over German monetary policy had been Mitterrand's core objective since 1983, when he had been obliged to give up his expansionary economic programme in order to remain within the EMS, and a unified Germany was a further alarm signal that a supranational monetary institution had become imperative.

Delors endorsed the French issue, arguing that a federal Europe was «the only satisfactory and acceptable response to the German question» (The Economist 1989: 50). The position of the UK was aligned with France as regards fear of a unified German power, but the means chosen to prevent it were diametrically opposed. According to Thatcher a more integrated Community would be more easily dominated by Germany; therefore the priority was not to strengthen integration but rather to boost expansion towards Eastern Europe, aiming at a looser and wider confederation, more difficult to manage and more unlikely to work effectively. Much more interesting was the position of Kohl, who tried to convince his partners that European integration and German unification were not contradictory processes: deepening and widening could be parallel steps, which Germany would accept only in exchange for European acceptance of German unification.

Notwithstanding Mitterrand's attempts to prevent it, German reunification preceded the EMU and in 1990 the first general elections crowned Kohl Chancellor of a united Germany. Using his position of strength he immediately endorsed not only the achievement of the EMU but also an authentic political union. Meanwhile, Thatcher had to leave Downing Street, essentially but not exclusively because of her intransigence towards further European integration, and Delors' influence was to reach its acme.

4. The Maastricht Treaty. What implications for the new EU?

The Maastricht Treaty was the political answer to German reunification and the end of the Cold War, and probably the best possible compromise in terms of national interest between the two main agents of European integration, France and Germany. Kohl proposed the political and institutional reform of the Community as the *sine qua non* of his acceptance of the EMU, with an eye to strengthening the European Parliament's prerogatives and fostering more cooperation in foreign and defence policy – something France was not so keen on. Despite Mitterrand's reservations the Franco-German axis was strengthened by France's acceptance of Kohl's conditions and two parallel conferences were suddenly launched, one on monetary union (in France's interests) and one on political union (in Germany's interests).

The main opponent to the creation of a common monetary union was the powerful Bundesbank, with which Kohl embarked on a major battle. Its claim was that economic convergence should precede any kind of monetary union, which naturally meant adaptation of the other Member States to the German standards of inflation, interest rate and budget deficit. Here for the first time the concept of 'two-speed' Europe emerged, when the Bundesbank proposed to initially implement the EMU only for a small number of countries, such as Germany, France and Benelux, with the possibility for others to join later after a first successful round of economic convergence.

The political conference (the one that was to establish the second and third pillars of the Maastricht structure) was a concession to Kohl, who could accordingly make the entire debate acceptable at home. Conversely, the monetary conference was the key objective of the other Member States, with France on the front line, to make German reunification compatible with European integration. At this conference, the price to be paid for EMU implementation was the design of the European Central Bank (ECB) on the model of the Bundesbank – full independence of any external political authority whatsoever and the fight against inflation as a statutory goal. France would have preferred a political supervision over the bank but was, on the contrary, forced to make its own central bank independent. The Bundesbank, led by Pöhl and then Tietmeyer, strongly campaigned for the new central institution to replicate the German model, believing that other countries could not understand the Germans' entrenched historical fear of inflation or the importance of complete independence from any political influence. This was made clear with the insertion of the famous 'no-bail out' clause in the treaty, now Article 125 of the Treaty on the Functioning of the European Union (TFEU), according to which the ECB may not to act as lender of last resort for countries in financial difficulty, which is incidentally one of the causes of the current sovereign debt crisis affecting the euro area.

The Treaty on the European Union (TEU) was finally signed on 7 February 1992, with the ambitious core element being the achievement of a full monetary union by the end of the decade. While the monetary conference was undoubtedly successful, it is difficult to define the political one as such. Basically it maintained the second and third pillars – Common Foreign and Security Policy (CFSP) and Justice and Home Affairs (JHA) – at intergovernmental level, excluding Community institutions from the substantial decision-making process on those matters, and was a major disappointment for Kohl. This failure was also due to the divergence between France and the UK on one side and Germany on the other *vis-à-vis* the ongoing situation in Yugoslavia, which contributed to undermine the idea that a common foreign policy was easily achievable. Nevertheless, the treaty was reported as a victory both by France, which could claim Germany was now indissolubly linked to the destiny of Europe, and by Kohl, who was assured that the European monetary regime would essentially be based on the German model, with the path towards an irreversible political unity.

After months of crisis and difficulty in the ratification process, the Maastricht Treaty came into force on 1 November 1993. The agreed convergence criteria for admission to the EMU were strict and modelled on German pretensions: in the year preceding the admission the inflation rate could not exceed the average of the three best performing countries by more than 1.5%; the annual nominal long-term interest rate could not exceed the average of the three best performing countries by more than 2%; the public deficit/GDP ratio could not exceed the threshold of 3%, as well as the public debt/GDP ratio could not exceed the threshold of 60%; finally, the exchange rate had to be maintained within the normal margins of the EMS pattern for at least two years without devaluations. These criteria would remain the bedrock of all subsequent reforms of European economic governance up to the present, including the Stability and Growth Pact (SGP), first introduced in 1997 and revised in 2005, and the so-called Fiscal Compact, agreed upon in 2012 (Eichengreen, Wyplosz 1998). All these instruments aim at assuring fiscal consolidation among Member States and basically strive for a coordination of national fiscal policies on the basis of intergovernmental bargaining.

5. The EMU's historic legacy 20 years on

The path which had begun in 1992 significantly evolved in the following 20 years and the process of European integration greatly advanced up to the Lisbon Treaty, which came into force on 1 December 2009. The integration of economic governance progressed even further, as the innovations achieved with the European Semester (2011), the Six Pack (2011), the Fiscal Compact (2012), the Europlus Pact (2012) and the still ongoing process of implementation of the Two Pack demonstrate.

Nevertheless, the very first years after Maastricht ratification were not easy. In 1992 several countries were obliged to devaluate and on the 'Black Wednesday', on 16 September, Britain even decided to pull the sterling out of the ERM as a consequence of rising German interest rates that pushed up the value of the D-mark and that of other currencies down. The crisis peaked in summer 1993, when Finance Ministers decided to enlarge the fluctuation band of the ERM from 2.5% to 15% in order to alleviate tension among currencies (Amato 2015).

The following year the ancestor of the ECB, the European Monetary Institute, was established with the aim of coordinating the monetary policies of the Member States. With the election of Jacques Chirac (May 1995) in France and the weakening of Kohl (October 1994) in Germany, the equilibrium within the Franco-German alliance changed (Feldstein 1997). This was clear during the dispute for the election of the first President of the ECB, when Chirac obtained the appointment of Jean-Claude Trichet, after a temporary compromise installing the Dutch Central Bank Governor, Wim Duisenberg, at the head of the new institution. The ECB would assume responsibility for monetary policy in the middle of 1998 and definitively substitute the European Monetary Institute in 1999 (Duisenberg 1998, 1999, 2000; Spaventa, Chiorazzo 2000).

As for the common currency, the final decision to call it 'euro' was made by the European Council in December 1995. The definitive entry into force of the EMU was to be on 1 January 1999 and the introduction of the new currency on 1 January 2002. In May 1998, 11 countries were considered eligible to enter the EMU, to the great satisfaction of Italy which was admitted despite its macroeconomic deficiencies (in 1995-96 the values of the deficit/GDP and debt/GDP ratio actually more than doubled the criteria established at Maastricht) largely thanks to the diplomatic ability of the Treasury Minister, Carlo A. Ciampi. Britain and Denmark opted out, Sweden decided not to participate and Greece would eventually join in 2001 (Noyer 1998).

If we consider the advantages and disadvantages the EMU has brought to its members, we could note that it is hard to claim that the euro area is an Optimal Currency Area[1]. The reason for this is largely due to the impact of asymmetrical shocks on the different economies of Member States and the low mobility of labour (Mundell 1961; McKinnon 1963; Giannini 2004). Monetary policy has been 'communitarized' through the first pillar of the Maastricht Treaty but fiscal policy has remained at national level, so that the general instruments of economic policy have been decoupled and economic governance has become much more complicated and difficult to harmonize (Randall *et al.* 2012). The progressive steps of European economic governance thus pursued an attempt at harmonization of national fiscal policies, firstly addressed through the SGP, which contains the balance budget rule and the provision of sanctions in case of excessive deficit. Even with its most recent modifications (in 2005 and 2011), that have substantially made it more flexible, the SGP has been severely criticized by most economic scholars since it prevents Member States from using 'countercyclical policies' – for example

1 According to Obstfeld *et al.* (2004) in an Optimal Currency Area the benefits of joining exceed the costs.

by an increment of public deficit in times of recession – compelling governments to use 'rules' rather than 'discretion'[2]. Further delegitimization came in 2003, when Germany and France pushed for and obtained a suspension of the excessive deficit procedure. Indeed, even after the subsequent modifications, the SGP still lacks an external and independent enforcer, its implementation depending on the European Council. The Fiscal Compact, signed in 2012 by 25 out of the 27 EU Member States, with the exclusion of the UK and the Czech Republic, continues on the same path, compelling Member States' governments to insert the balance budget clause in national legal systems, preferably at constitutional level.

To sum up, the way the EMU and the euro were conceived in Maastricht is very much linked to the crisis that the Eurozone and the EU as a whole are currently going through. The Maastricht compromise involved political, historical and economic dynamics that contributed to shape Europe and its economic governance as we know them now. It is certain that a change in the current model can only be achieved through a similar effort of 'diplomacy' in which, once again, the main powers will play the key role. This paper assumed a historical perspective because the analysis of facts clearly shows that the current structure of European economic governance is the result not so much of an irrefutable economic theory, but of deliberate political choices: setting inflation targeting as the main ECB goal, not making it accountable to any political body and preventing Member States from using countercyclical policies in case of necessity.

6. Conclusions

The euro began to circulate in 2002 but was conceived and formally established through the signature of the Maastricht Treaty in February 1992. The main reason for its adoption lay in lessons learned from the past, according to which fluctuating currencies were the most reliable predictor of political and economic unrest (European Central Bank 2000, 2001). The first two structural remedies to this problem saw the light respectively in 1972 and 1979, and both were semi-fixed exchange arrangements: the 'Snake' and the ESM. These two attempts were frustrated in the 1980s by the growing economic prevalence of Germany and critically undermined by the rising power of the Bundesbank, briefly making the D-mark the dominant currency of both systems. Through the Maastricht Treaty European leaders expressed their conviction that the only way to definitively stabilize the system was by fusing currencies into a common one: in their view, end-

2 In October 2002 the former President of the EC Romano Prodi defined the SGP as simply 'stupid' for these very reasons: <http://www.telegraph.co.uk/finance/2830598/Euro-Stability-Pact-is-stupid-says-Prodi.html>.

ing the exchange rate fluctuation could provide the European Community with the means to foster growth, employment and investment (European Commission 2008, 2010).

As the current crisis demonstrates, this was not the case. The way in which the new EMU was set up prevents Member States from implementing the necessary measures to grow, strangling them with fixed rules that rule out discretion – which has proved to be catastrophic in economic policy. The years following Maastricht did not change the path, but stepped up the progress towards fiscal harmonization and consolidation up until very recent times. Not only did these policies prove ineffective in restoring a favourable economic cycle – as happened and is happening all over the world except for the Eurozone – they also entailed the risk of sidestepping democracy and jeopardising the very notion of a European 'Union' (Sen 2012; Aglietta 2012; Spinelli 2014; Vaciago 2014). Courageous changes are required if the EMU is to survive and, in the final analysis, if the entire EU project is not to crumble (Blinder *et al.* 2013; Orphanides 2010).

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Time to Reconsider Status: The IMF, the EU, the Euro Area and Its Sovereign Debt Crisis

Jan Wouters, Thomas Ramopoulos[*]

1. Introduction

The global financial crisis that struck the world in 2008 removed any doubts about the relevance of the International Monetary Fund (IMF or 'Fund') in international economic governance[1]. Furthermore, the subsequent euro area sovereign debt crisis gave the Fund the opportunity to recalibrate its role as a *de facto* lender of last resort open to cooperation with regional organisations in order to fulfill its mandate (Seitz, Jost 2012; IMF 2010c). For the first time the IMF found itself involved in multiple rescue programmes of euro area Member States. As a member of the so-called Troika – also including the European Commission ('Commission') and the European Central Bank (ECB) – the IMF has exercised significant influence on the extensive economic policy reforms of euro area Member States that received financial assistance. The Fund has thereby become a significant actor in European economic governance. In addition, the crisis brought to light certain defects in the set-up of the EU's Economic and Monetary Union (EMU). This includes, most prominently, its asymmetric nature, where the economic governance component had been severely underdeveloped compared with the monetary one (Issing 2011; Baimbridge *et al.* 2012). This has prompted an overhaul of European economic governance in order to prevent and overcome future crises. Among other reforms the novel crisis management mechanisms of the EU and the euro area Member States seem to have been influenced by

* Thomas Ramopoulos' contribution to this chapter was made prior to joining the European Commission as an official. His views expressed herein are strictly personal.

1 For an analysis on the apparent irrelevance of the IMF prior to the 2008 financial crisis, see *inter alia* Eichengreen 2007.

Max Guderzo and Andrea Bosco (edited by), *A Monetary Hope for Europe: the Euro and the Struggle for the Creation of a New Global Currency* ISBN 978-88-6655-965-8 (print) ISBN 978-88-6655-966-5 (online)

the governance structure and function of the IMF; moreover, they envisage a role for the Fund in their future financial assistance programmes[2].

The present contribution focuses on the contemporary and possible future role of the IMF in European economic governance. It is submitted that it is in the interest of the EU/euro area to strengthen its representation[3] in, and thereby its impact on the work of, the IMF[4]. The Lisbon Treaty has created the potential for a strengthened presence of the euro area (not necessarily the EU) in the IMF. According to the new Article 138(1) of the Treaty on the Functioning of the European Union (TFEU), euro area Member States have the obligation to adopt common positions in international fora. Moreover, Article 138(2) TFEU provides for the possibility for euro area Member States to unify their representation in international fora. However, the relationship between the external representation of the EU and of the euro area remains to be clarified in practice, since the Treaties are silent in this respect. This paper examines the potential and limits of EU law with regard to a unification of the representation of the EU or the euro area in the IMF. For reasons of space, it does not analyze whether *IMF law* allows for a strengthened or even unified representation of the EU or the euro area in the Fund (Wouters *et al.* 2013).

First, the current status of the EU in the IMF is described briefly (section 2). Secondly, the role of the IMF in European economic governance before and after the crisis is revisited, as illustrated, among others, in EU legislation (3). The focus thereby lies in particular on developments after the advent of the crisis and the cooperation between the EU and the Fund in tackling financial problems both in non-euro area and euro area Member States. In addition, attention is paid to the influence of the IMF on the revamping of European economic governance through, among others, the establishment of robust crisis management mechanisms. The findings are that the Fund will continue to have some role in European economic governance, at least in the medium term. It is therefore in the interest of the EU/euro area to

[2] Parts of the preventive structures of European economic governance have also been modeled closely or have been inspired by the IMF. This is the case with the EU surveillance mechanism, which shares similarities in its goals, mandatory nature and periodicity with that of the IMF. However, since the IMF has no formal role in it, an analysis of this surveillance mechanism falls outside the scope of this paper. See Bergthaler 2013: 191-193.

[3] See recently also Wouters, Van Kerckhoven 2012; Wouters *et al.* 2013. For an analysis of the institutional changes within the IMF to accommodate the establishment of the EMU see Broome 2013.

[4] Although this discussion falls outside the scope of our present analysis, recent developments in Ukraine, which necessitated economic assistance from the EU and the IMF, underlined among others the importance of having a strong EU or at least euro area presence in the Fund as part of a concerted effort to promote EU foreign policy objectives also through the work and programmes of the IMF.

strengthen its representation in, and impact on the work of, the IMF. Towards the end of the contribution (4), the feasibility of this proposition is examined in light of the potential and limits of EU law.

2. Before and after the crisis: unchanged status of the EU in the IMF

The EU does not enjoy any formal status in the IMF. It is represented in the Fund by two of its institutions, the ECB and the Commission, as well as by its Member States. The ECB has observer status at the IMF Executive Board[5] and can express its view about European monetary matters during the Board's meetings (Ahearne, Eichengreen 2007: 140). The Commission has observer status at the Development Committee. Given their limited status in the Fund, the two institutions have a rather circumscribed role in the work of the IMF. The responsibility of representing the EU in all other functions of the IMF, therefore, falls on the shoulders of EU Member States, which are all full member countries of the Fund (Mahieu *et al.* 2005: 499). However, EU Member States are dispersed within the Fund in different constituencies, sometimes comprising a combination of euro area Member States, non-euro area Member States and third countries (Mahieu *et al.* 2003: 181). This leads to a diminished visibility and, arguably, influence in the Fund, despite the fact that EU Member States jointly hold a quota of more than 30 percent (Wouters, Van Kerckhoven 2012; Bini Smaghi 2004: 230; Smits 2009: 12).

In order to tackle this problem, two coordination mechanisms exist in Washington and Brussels, respectively. The group of EU representatives to the IMF (EURIMF) convenes in Washington, whereas the Sub-Committee on IMF (SCIMF) operates under the Ecofin Council in Brussels. However, coordination through these two mechanisms is considered insufficient and often fails to produce common EU positions and, ultimately, statements in the Fund (European Commission 2008: 142). The international financial crisis and the euro area's sovereign debt crisis worsened this problem since they often laid bare «strongly diverging national interests among [EU Member States]» (Schwarzer 2012: 303)[6]. At the same time Member States have been reluctant to see a further strengthening of EU representation in the Fund through unification since this would come at the expense of them having their own voice heard (Schwarzer 2012: 311). They discretely oppose a unification of their representation in the IMF (Ahearne, Eichengreen 2007: 145; Barents 2008: 584; Priollaud, Siritzky 2009: 259).

[5] See Decision no. 11875 (99/1), 21 December 1998, substituted by Decision no. 12925 (03/1), 27 December 2002, as amended by Decisions no. 13414 (05/01), 23 December 2004, 13612 (05/108), 22 December 2005, and 14517 (10/1), 5 January 2010.

[6] For examples of opposing views among EU Member States on issues pertaining to the reform of the international monetary system, see also Gnath, Schmucker 2011: 20-23.

Still, in light of the recent crises, it has become clear that the EU/euro area needs to strengthen its representation in the IMF if it wants to co-shape decision-making in the Fund (Schwarzer 2012). As will be seen below, the increased role of the Fund in European economic governance makes the need for a more effective representation all the more pressing.

3. The IMF in European economic governance

Before the recent crises the IMF played a rather modest, if any, role in European economic governance. Still, it was not disregarded, especially in monetary issues. In addition, the IMF had become an actor alongside the then European Community since the early 1990s in providing assistance to the countries of Eastern Europe. However, with the advent of the European sovereign debt crisis the IMF took centre stage in European economic governance, especially in the latter's crisis management arm. It has cooperated with EU institutions in rescue packages to non-euro area and euro area Member States, setting a precedent for other such programmes. Its model has also been taken up by the novel euro area crisis management mechanism, the European Stability Mechanism (ESM), which, like its predecessors, the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF), envisages a role for the IMF in future financial assistance programmes for euro area Member States.

The EU had been coordinating with the IMF since the early 1990s in its efforts to assist and gradually integrate the countries of Eastern Europe. When providing medium-term financial assistance (MTF) to these countries, the relevant Council Decision stipulated that the Commission would manage the loan «in a manner consistent with any agreement reached between the IMF and [the borrowing country]»[7] and that «[t]he Commission [would] verify at regular intervals, in collaboration with the Monetary Committee and in close co-ordination with G-24 and the IMF, that the economic policy of [the borrowing country was] in accordance with the objectives of this loan and that its terms and conditions [were] being fulfilled»[8]. In the same spirit, association agreements with these countries provided for the possibility of financial assistance by the Community. This was conditioned *inter alia* on continued compliance by the receiving States with IMF programmes aimed at transforming their economy. Thus, the association agreement with Poland provided:

> This financial assistance is subject to Poland's presentation of IMF supported programmes in the context of G-24, as appropriate, for convertibility and/

[7] Council Decision of 25 February 1991 providing medium-term financial assistance for the Czech and Slovak Federal Republic, (91/106/EEC), 2.3.1991, O.J. L 56/24, Article 1.

[8] *Ibidem*, Article 2, second subparagraph.

> or for restructuring its economy, to the Community's acceptance thereof, to Poland's continued adherence to these programmes and, as an ultimate objective, to rapid transition to reliance on finance from private sources[9].

These agreements reveal a limited involvement of the IMF aimed at providing financial assistance to the countries of Eastern Europe, which were to become EU Member States a decade later. The volume of the loans given in accordance with these agreements was comparatively small. In any case, the implementation of the conditions that were attached to them did not pose any immediate existential threat to the survival of the EU or the euro area. Successful EU-IMF coordination was by no means as important as it is today. Besides, these loans were given in a very different era, when the IMF was dominated by the US and EU Member States. These transatlantic partners mostly shared common interests in the policy fields covered by the IMF. Therefore, it was easier and far less pressing to coordinate the actions of the EU and the IMF despite the former's lack of membership in the Fund.

However, in October 2008, 32 years after it had last provided financial aid to a EU Member State (the United Kingdom), the IMF was asked to step in and give financial assistance together with the EU, this time to Hungary. The EU assisted Hungary financially through its Balance-of-Payment (BoP) Assistance Facility[10]. It was envisaged that this first EU-IMF joint programme «could [...] become a reference on how to proceed should further cases of a similar nature arise» (IMF 2008: 7). Indeed, it was followed by the programmes in Latvia in December 2008[11] and Romania in May 2009[12]. In addition, the EU and the IMF agreed in 2011 and again in 2013 to provide Romania with joint pre-cautionary financial assistance programmes with the last programme expected to run until the end of September 2015[13]. These programmes had in common that they were addressed to non-euro area Member States. There-

9 Europe Agreement establishing an association between the European Communities and their Member States, of the one part, and the Republic of Poland, of the other part, 31.12.1993, O.J. L 348/2, Article 99.

10 BoP was established by Council Regulation (EC) no. 332/2002 of 18 February 2002, 23.2.2002, O.J. L 53/1. For EU assistance to Hungary see Council Decision of 4 November 2008 providing Community medium-term financial assistance to Hungary (2009/102/EC), 6.2.2009, O.J. L 37/5.

11 See Council Decision of 20 January 2009 granting mutual assistance to Latvia (2009/289/EC), 25.3.2009, O.J. L 79/37; Council Decision of 20 January 2009 providing Community medium-term financial assistance for Latvia (2009/290/EC), 25.3.2009, O.J. L 79/39 as amended by Council Decision of 13 July 2009 (2009/592/EC), 4.8.2009, O.J. L 202/52. See also IMF 2009a.

12 See Council Decision of 6 May 2009 providing Community medium-term financial assistance for Romania (2009/459/EC), 13.6.2009, O.J. L 150/8. See also IMF 2009b.

13 See Council Decision 2011/288/EU of 12 May 2011 providing precautionary EU medium-term financial assistance to Romania, O.J. L 132/15; Council Decision 2013/531/EU of 22 October 2013 providing precautionary EU medium-term financial assistance to Romania, O.J. L 286/1.

fore, from a EU law perspective they were not problematic as long as they complied with Article 143 TFEU (former Article 119 EC), which provides for a prior involvement of or at least consultation with the Commission and Council with regard to the appropriate way to address a balance of payments problem. Compliance with this condition proved to be slightly more problematic in the case of Latvia, where EU authorities disagreed with the IMF on the question of the devaluation of the Latvian currency, the lats, as part of the reforms in the country. This disagreement was resolved with the IMF desisting from asking for a devaluation and the EU undertaking the bulk of financial support to Latvia. Based on the lessons learned from these three EU-IMF joint programmes in non-euro area Member States and with the aim of making the best use of the respective competitive advantages of the two organisations, the EU developed guidelines on future joint EU-IMF programmes in the context of BoP assistance, although the latter is not formally linked to IMF programmes[14]. These guidelines were created «under the assumption that any future BoP assistance programme for EU members will be in coordination with the Fund» (IMF 2011b: 35). Clearly, the EU expected the IMF to play a role in future financial assistance programmes to non-euro area Member States and tried to institutionalise EU-IMF cooperation in this field.

The involvement of the IMF in financial assistance programmes to EU Member States did not end with the 'new' Member States. The sovereign debt crisis found the euro area without an instrument able to support financial stability in its Member States since BoP is not available for them. Once it became clear in the first months of 2010 that Greece needed financial assistance, participation of the IMF in a rescue package for the country was sought. Eventually, in May 2010 the IMF agreed to participate in a 3-year financial rescue package for Greece. This joint EU-IMF programme consisted of €80 billion in bilateral loans by EU Member States centrally pooled by the Commission, and €30 billion more contributed by the IMF under a Stand-by Arrangement (SBA) (IMF 2010a; see also IMF 2010b). In March 2012 a second adjustment programme for Greece was approved committing €130 billion more, principally from EU Member States and secondly from the IMF[15]. This time the EU contribution was made by the new temporary euro area financial stability facility, the EFSF[16]. By the end of 2010 a 3-year financial

[14] *EU Guidelines on EU-Fund Coordination*, doc. ECFIN/G/C ARES(2009)365646(REV), unpublished. For a summary see IMF 2011b: 35.

[15] *Statement by the President of the Eurogroup, Jean-Claude Juncker*, 14 March 2012, <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/128941.pdf>; IMF 2012a.

[16] A third adjustment programme for Greece was being negotiated at the time this chapter went to press. Following a request by Greece for a three-year loan to the Eurogroup President and the Board of Governors of the ESM on 8 July 2015 on the basis of Article 13 of the ESM Treaty, an agreement in principle was reached in the morning of 13 July 2015 on a new ESM programme for Greece. See European Commission 2015a;

assistance programme for Ireland was adopted (IMF 2010d). Ireland was to receive €62.5 billion by the EFSM, the EFSF, some EU Member States in bilateral loans and Irish contributions, and €22.5 billion by the IMF under an Extended Fund Facility (EFF) arrangement (IMF 2010e). In addition, Portugal also asked for financial assistance leading to the adoption in May 2011 of another joint rescue programme worth €78 billion out of which up to €52 billion were to be made available by the EFSM and the EFSF and €26.5 billion were to be allocated by the IMF, again under an EFF arrangement (IMF 2011a). Lastly, Cyprus and Spain asked for financial assistance on 25 June 2012. Spain only requested and received financial assistance of up to €100 billion for the recapitalisation of its financial institutions[17]. In the end only €41.4 billion were allocated to Spain. In the case of Spain the IMF only offered technical assistance both to the negotiations leading to the assistance and to its implementation and monitoring[18]. On the contrary the Fund has been fully involved in the €10 billion economic adjustment programme of Cyprus, which was fully agreed by the Commission, the ECB and the IMF in April 2013; €9 billion will be contributed by the ESM and the remaining amount by the Fund[19]. As first signs of apparent success of the financial assistance programmes, on 8 December 2013 Ireland successfully exited the EFSF programme, followed by Spain on 31 December 2013, which also exited its ESM programme[20]. Portugal exited its programme on 12 June 2014.

Euro Summit Statement, SN 4070/15, 12 July 2015, <http://www.consilium.europa.eu/en/press/press-releases/2015/07/12-euro-summit-statement-greece/>. Until the new programme comes into force, Greece will receive assistance from the EFSM in the form of a bridge loan worth €7 billion disbursed at once and linked to economic policy conditionality. See Council Implementing Decision (EU) 2015/1181 of 17 July 2015 on granting short-term Union financial assistance to Greece, 18.7.2015, O.J. L 192/15. On the efforts of the EU, and in particular the Commission, to provide support for the Greek economy, see also European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *A New Start for Jobs and Growth in Greece*, COM(2015) 400 final, 15/7/2015.

17 See *Financial Assistance Facility Agreement between European Stability Mechanism and the Kingdom of Spain, the Bank of Spain and Fondo de Reestructuración Ordenada Bancaria*, <http://www.esm.europa.eu/pdf/FFASpnMainAgreementExecution130214.pdf>.

18 See *Terms of Reference for Fund Staff Monitoring in the Context of European Financial Assistance for Bank Recapitalization*, 20 July 2012, <http://www.imf.org/external/np/country/2012/esp/spaintor.pdf>.

19 See *Financial Assistance Facility Agreement between European Stability Mechanism and the Republic of Cyprus and Central Bank of Cyprus*, <http://www.esm.europa.eu/pdf/ESM%20FFA%20Cyprus%20publication%20version%20final.pdf>; IMF 2013a.

20 See EFSF, *Conclusion of EFSF Financial Assistance Programme for Ireland: An Overview*, 8 December 2013, <http://www.efsf.europa.eu/attachments/Irish%20exit%20presentation.pdf>; and ESM, *Conclusion of ESM Financial Assistance Programme for Spain: An Overview*, 31 December 2013, <http://www.esm.europa.eu/pdf/Spanish_exit.pdf>.

All three Member States are currently under a so-called post programme surveillance (PPS) until at least three quarters of the financial assistance provided to them has been paid back. In the context of PPS, the Commission, in coordination with the ECB, reviews the economic, fiscal and financial developments in these Member States and produces assessments thereon (European Commission 2015b, 2015c).

Germany, the largest economy of the euro area, insisted on the involvement of the IMF in euro area rescue programmes (Wiesmann, Peel 2010; Seitz, Jost 2012: 9-10), contrary to the wishes of the ECB[21]. Germany's pressure in the direction of the participation of the IMF in such programmes as a *sine qua non* became yet more pronounced in the protracted negotiations for a third adjustment programme for Greece, although the government of the latter was openly opposed to it. As analysed below, as a result of this insistence, the role of the IMF has by now been institutionalised in the crisis management architecture of the euro area. The main reason for this insistence was that the IMF is considered to be largely immune to political pressures within the EU. Therefore, it is able to introduce strict conditionality in the financial assistance packages and subsequently enforce it. Moreover, it has an accumulated experience from past programmes ranging from their elaboration and negotiation to their monitoring and execution. In retrospect though, the IMF seems at times to have been overtaken by political decisions within the EU with regard to its participation in the financial assistance programmes of Greece, Ireland and Portugal. Still, these programmes as well as the ones that followed them bear the characteristics of standard IMF programmes[22]. The countries receiving them have to comply with strict conditionality. They have to take prior actions, meet quantitative performance criteria and indicative targets, as well as structural benchmarks, as these are delineated in their respective rescue programmes (IMF 2012b: 35, 128-135; see also IMF 2013b: 1-4; European Commission 2012). The adequate implementation of the programmes is monitored on a quarterly basis by the Troika, namely the Commission, the ECB and the IMF. The EU institutions and the IMF carry out their assessments on the progress of the programme separately. These as-

[21] Congressional Research Service 2010: 5. With regard to the stance of the ECB on the matter see ECB, *Introductory Statement with Q&A*, 4 March 2010, <http://www.ecb.int/press/pressconf/2010/html/is100304.en.html>, where the then President of the ECB, J.-C. Trichet, opined that «I do not believe that it would be appropriate to introduce the IMF as a supplier of help through standby arrangements or through any such kind of help. […] The fact is that the conditionality inside the euro area has to be decided, in our opinion, by the peers, according to the Stability and Growth Pact and the European framework as it functions».

[22] Although some commentators considered these programmes to be less strict than previous ones in light of their size relative to the quotas of the borrowing countries, European observers suggested that the IMF was the more objective actor within the Troika. See IEO 2013: 29.

sessments respectively inform the Eurogroup and the IMF executive board, which have to approve independently of each other the further allocation of funds to the country receiving assistance. Thus, the IMF has been instrumental in devising and executing the rescue programmes to the euro area Member States. Clearly, this role has a significant impact on the euro area if only for the simple reason that the stability of the euro area still depends partly on the financial stability of its weakest members.

The development of the euro area crisis and the adoption of these rescue programmes seem to have institutionalised the role of the IMF in the crisis management component of European economic governance. Regulation 407/2010 of 11 May 2010 establishing a European Stabilisation Mechanism[23], the EFSM, provides that the «activation [of the EFSM] will be in the context of a joint EU/International Monetary Fund (IMF) support»[24]. Still, a Member State wishing to obtain financing from the IMF should «first consult the Commission»[25]. It is further worth noting that the procedure to secure financial assistance by the EFSM, as described in Article 3 of the Regulation, closely follows that of the IMF[26]. This is not surprising for two reasons. First, it is normal for the EU to adopt the procedure of the Fund given the Fund's expertise in offering financial assistance to countries under strict conditionality. Second, opting for a different procedure than that of the Fund would unnecessarily complicate efforts to have joint EU-IMF programmes.

At the same time, the EFSF, a special purpose vehicle, was established by the euro area Member States on 7 June 2010[27]. In the preamble of the EFSF Framework Agreement «[i]t is envisaged that financial support to euro-area Member States shall be provided by EFSF in conjunction with the IMF»[28]. Furthermore, the negotiation of a Memorandum of Understanding (MoU) with a euro area Member State seeking assistance by the EFSF will be made by «the Commission (in liaison with the ECB and the IMF)»[29].

Soon thereafter EU Member States established a permanent financial stability mechanism, the ESM[30], which entered into force on 8 October 2012

[23] Council Regulation (EU) 407/2010 of 11 May 2010 establishing a European Stabilisation Mechanism, 12.5.2010, O.J. L 118/1 (EFSM).

[24] EFSM, Preamble, fifth recital.

[25] EFSM, Article 3(8).

[26] EFSM, Article 3.

[27] Decision of the Representatives of the Governments of the Euro Area Member States Meeting within the Council of the European Union – Decision of the Representatives of the Governments of the 27 EU Member States, 9614/10 of 10 May 2010; European Financial Stability Facility, Articles of Incorporation, <http://www.efsf.europa.eu/attachments/efsf_articles_of_incorporation_en.pdf> (03/13).

[28] EFSF Framework Agreement, Preamble Recital (1).

[29] EFSF Framework Agreement, Article 2(1)(a).

[30] Treaty establishing the European Stability Mechanism (ESM), <http://consilium.europa.eu/media/1216793/esm%20treaty%20en.pdf>.

and overtook the EFSF and the EFSM as of July 2013[31]. The ESM is modeled after the EFSF, but attempts to institutionalise further the role of the IMF in all stages of future programmes. The preamble of the Treaty establishing the ESM provides that

> [t]he ESM will cooperate very closely with the International Monetary Fund (IMF) in providing stability support. The active participation of the IMF will be sought, both at technical and financial level. A euro area Member State requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF[32].

In addition, IMF representatives can be invited on an *ad hoc* basis to meetings of the Board of Governors of the ESM[33]. Furthermore, the ESM is entitled, «for the furtherance of its purposes, to cooperate, within the terms of this Treaty, with the IMF» and with other States or international organisations[34]. The procedure for granting financial support provides that «[w]herever appropriate and possible» the IMF is to be involved in the prior assessment of the public debt sustainability of a country applying for assistance[35]. The IMF is also to participate in the subsequent negotiation of the MoU «detailing the conditionality attached to the financial assistance facility»[36]. Lastly, the IMF is expected to conduct the monitoring of the implementation of the agreed programme together with the Commission and the ECB[37].

The governance structures of the ESM are also similar to those of the IMF: a Board of Governors, a Board of Directors and a Managing Director[38]. The influence of the IMF is further prevalent in other provisions, such as the one allowing for the possibility of private sector involvement in adjustment programmes[39] or the one giving ESM loans preferred creditor status[40].

It follows from the above that the role of the Fund in the EU with regard to providing financial assistance to Member States is far from incidental or temporary. The experience of the programmes for Hungary, Latvia and Romania led to the drafting of the Commission Guidelines that envisage IMF participation in future BoP programmes. In addition, the EU and the IMF provided joint rescue packages to euro area Member States that bore the char-

[31] Conclusions of the European Council, 16-17/12/2010, EUCO 30/1/10 REV 1. Still, the EFSF will remain active until the completion of the financing of the programmes for Greece and Portugal.

[32] ESM, Preamble, eighth recital.

[33] ESM, Article 5.

[34] ESM, Article 38.

[35] ESM, Article 13(1)(b).

[36] ESM, Article 13(3).

[37] ESM, Article 13(7).

[38] ESM, Articles 4-7.

[39] ESM, Preamble, twelfth recital.

[40] ESM, Preamble, thirteenth recital.

acteristics of traditional IMF loans. What is more, the EFSM, the EFSF, and their successor, the ESM, provide for a continued role of the IMF in financial assistance programmes in the future. The ESM is even modeled to a great extent after the IMF. These developments manifest that the Fund will have some role in the financial crisis management structures of the EU, at least in the medium term, even if the Commission gradually obtains the expertise to devise and monitor the implementation of financial assistance programmes.

In light of the desire of EU Member States to keep the Fund involved in guaranteeing financial stability within the EU, and the apparent international rebalancing of powers at the expense of Europe in the IMF, it is in the strategic interest of the EU to try to be more directly involved in the governance of the IMF so as to pursue its agenda more successfully. It is submitted that the best way to do this would be through strengthening the EU/euro area's representation in the Fund. However, the question arises whether this is legally feasible from the perspective of EU law.

4. EU law on the representation of the EU and the euro area in the IMF

The Lisbon Treaty has brought forward a number of changes in the direction of a more unified representation of the euro area, but not necessarily of the EU, in the IMF. According to Article 138(1) TFEU, euro area Member States have to reach common positions on economic and monetary issues that are the subject matter of International Financial Institutions and Conferences (IFICs). Article 138(2) TFEU *enables* ('may') the Council to adopt appropriate measures, on a proposal of the Commission and after consulting the ECB, to ensure a unified representation at the IFICs[41]. This formulation stands in contrast with that of the former Article 111(4) EC, which *obliged* the Council to adopt measures regarding representation (Smits 2009: 4; Piris 2010: 306)[42]. However, the reference to a *unified representation* of the euro area is novel[43]. In addition, the previous reference to the Community (now the Union) is missing:

[41] Ahearne and Eichengreen (2007: 162) and Bini Smaghi (2004) argue that the IMF would be the best starting point for consolidating Europe's representation into a single chair as the European preferences are relatively homogenous in this institution. Smits (2009: 34) disagrees.

[42] Article 111(4) TEC stipulated: «Subject to paragraph 1, the Council, acting by a qualified majority on a proposal from the Commission and after consulting the ECB, shall decide on the position of the Community at international level as regards issues of particular relevance to economic and monetary union and on *its representation*, in compliance with the allocation of powers laid down in Articles 99 and 105» (emphasis added).

[43] For the other differences between the two provisions, see Piris 2010: 305-306. Some of the adaptations brought about by Article 138 TFEU were already part of the discussion during the Convention on the future of Europe, Final Report of the Working Group VII on external action, para. 13; Final Report on the Working Group VI on Economic Governance, CONV 357/02, 21/10/2002, Brussels, WG 17, V.2.

> *Article 138*
> (1) In order to secure the euro's place in the international monetary system, the Council, on a proposal from the Commission, shall adopt a decision establishing common positions on matters of particular interest for economic and monetary union within the competent international financial institutions and conferences. The Council shall act after consulting the European Central Bank.
> (2) The Council, on a proposal from the Commission, may adopt appropriate measures to ensure unified representation within the international financial institutions and conferences. The Council shall act after consulting the European Central Bank.
> (3) For the measures referred to in paragraphs 1 and 2, only members of the Council representing Member States whose currency is the euro shall take part in the vote. A qualified majority of the said members shall be defined in accordance with Article 238(3)(a).

Read together, these changes show that the Treaties recognise the differing levels of integration within the EU and, therefore, allow for a unified international representation of the euro area (Piris 2011: 39). Article 138 TFEU goes beyond just an enhancement of existing coordination mechanisms among all EU Member States since it opts for a «unified representation» of the euro area based on «common positions on matters of particular interest for economic and monetary union». What is more, it places the adoption of common positions and measures for a unified euro area representation in IFICs in the hands of the Council, with only the euro area Member States having a right to vote and allowing for a decision to be taken with qualified majority (Article 138[3]), and not in loose cooperation mechanisms at a lower level.

Improving the existing coordination mechanisms would not address the main reason currently precluding the EU from reaching a common position in the IMF. This reason is that all EU Member States participate in coordination mechanisms, although only euro area Member States have pooled their monetary policies and are steadily integrating their economic policies[44]. Besides, even if internal coordination improved, it would still be difficult to present and defend a common EU position within the IMF given the dispersal of EU Member States in different constituencies together with third countries.

Alternatively, a possible rearrangement of euro area Member States in one or more euro area constituenc(y)(ies) in the IMF seems to be in compliance with the letter and spirit of Article 138 TFEU. Such a development would create the external conditions and the incentive for euro area Member States to comply with their obligations under Article 138(1) TFEU with regard to the IMF. In addition, the possibility offered by Article 138(2) TFEU would materialise in practice by overcoming the current problems of coor-

[44] See European Council, The President, *Towards a Genuine Economic and Monetary Union: Interim Report*, 12/10/2012. Also, European Commission, Communication from the Commission: *A Blueprint for a Deep and Genuine Economic and Monetary Union. Launching a European Debate*, COM(2012) 777 final/2, 30/11/2012.

dination between euro area and non-euro area Member States and of mixed constituencies. This also seems to be the view of the Commission, which in its 'Blueprint for a Deep and Genuine Economic and Monetary Union' issued on 30 November 2012 suggests the creation of euro area constituencies as a first step toward a unified euro area representation in the Fund[45]. However, it is submitted that the creation of a single euro area constituency containing all or most euro area Member States is preferable to a rearrangement of euro area Member States in multiple euro area constituencies. This would allow euro area Member States to decide, unencumbered by non-euro area Member States or third States, who will be responsible to conduct the unified representation of the euro area in the Fund (Barents 2008: 590)[46].

Eventually, a euro area accession to the IMF succeeding euro area Member States there, could be envisaged. Still, this development would require overcoming legal concerns regarding, among others, the lack of international legal personality of the euro area. It would also require a prior conferral of all the powers necessary to represent Member States on all matters addressed in the Fund (Wouters *et al.* 2013).

Contrary to what is the case with the euro area, there are no specific provisions in the EU Treaties dedicated to the representation of the entire EU in IFICs, and in particular in the IMF. According to Article 142 TFEU EU Member States only have to treat their exchange rate policy as a matter of common interest. This provision does not prevent them from negotiating independently on a number of IMF issues, but merely rules out the use of currency exchange rates as a beggar-thy-neighbour policy. EU Member States that are not members of the euro area are not directly dependent upon, or bound by, decisions in the monetary field[47]. In this sense, not much has changed for non-euro area Member States after the Lisbon Treaty.

Thus, EU law enables the euro area to unify its representation at the IMF. Political and economic realities also call for such a development, although the political environment internationally and in the EU does not seem conducive to it (yet). A single, or at least a number of, euro area constituencies would be in compliance with the EU Treaties and would allow the euro area to advance more successfully its interests and arguments in the Fund, overcoming the observed fragmentation in its external representation (Smith 2012: 26). For the other EU Member States not much has changed in terms of an obligation to have a unified position or representation in the IMF. A

45 European Commission, Communication from the Commission: *A Blueprint* cit.: 25; and Annex II: 46-48.

46 On the debate on who should be representing euro area Member States in the Fund, see Wouters *et al.* 2013.

47 Still, EU Member States will have to uphold their obligations from the exchange-rate agreement (ERM II) between them and the euro area to the extent that these Member States participate in ERM II.

single euro area membership succeeding to those of its Member States could be envisaged in the future. In practice, however, nothing has happened yet and the voice of both the EU and the euro area within the IMF still largely depend on the individual preferences of Member States and loose coordination mechanisms (Bini Smaghi 2004: 236).

5. Conclusion

The international financial crisis and the European sovereign debt crisis brought to light the deficiencies of European economic governance and prompted the participation of the IMF in rescue efforts for the weakest economies of EU Member States. The EU has been cooperating with the IMF to provide financial assistance to both non-euro area and euro area Member States. This has led to a significant deepening as well as rebalancing of the EU-IMF relationship. Ongoing joint EU-IMF adjustment programmes in Greece, Ireland and Portugal indicate that the IMF will continue to play a non-negligible role in efforts to maintain financial stability in the euro area. While strengthening European economic governance arrangements, EU and, in particular, euro area stakeholders have drawn important lessons from these rescue programmes and the role of the Fund therein. The Commission Guidelines for future BoP facilities for non-euro area Member States envisage IMF participation. More importantly, the EFSM and the EFSF, as well as their successor, the ESM, provide for a role of the IMF in financial assistance packages. These developments indicate that the EU envisages a role for the IMF should other financial crises arise in Member States. For this reason the EU, or at least the euro area, has an interest in becoming more influential in the work and decision-making of the IMF through the strengthening of its representation.

At present the EU can only be represented by its Member States in the IMF. The dispersal of Member States over different constituencies and their failure to coordinate among themselves prevents the EU from pushing its agenda successfully in the Fund. However, the coming into force of the Lisbon Treaty offers an opportunity, as far as the EU legal framework is concerned, for the euro area to strengthen and even unify its representation in the IMF. Article 138 TFEU obliges euro area Member States in the Council of the European Union to agree on common positions in the IMF whereas it allows for the unification of their representation. At the time of writing, though, euro area Member States have not yet attempted to capitalise on this opportunity. One wonders why it takes the Commission so long to come with a proposal.

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PART II

Financial, Fiscal and Monetary Reforms for the Stabilization of the Euro

Integration without Convergence in the European Currency Area

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1. Introduction

The monetary union was expected to boost convergence within the European currency area. Harsher competition among firms in wider goods' markets would have promoted homogeneous prices and fostered trade. After the end of the exchange rate risk and the reduction in the default risk, much lower interest rates and higher asset substitutability in capital markets would have favoured cross-border interconnections among banks and improved the financing conditions for the corporations. While these developments did occur, the financial crisis and the subsequent Great Recession have provoked the rolling-back of many progresses in market integration within the Eurozone. The worrying lack of convergence between the 'advanced' Core[1] and the 'backward' Peripheral[2] countries which joined the European Monetary Union (EMU) since its beginning has put back on stage the question about whether the Eurozone fulfils the optimality criteria for a currency area.

In section 2, we assess the optimality conditions for the European currency area and analyse whether the costs of renouncing the exchange rate policy instrument were balanced by the benefits stemming from the appropriate degrees of symmetry and labour market flexibility for a given degree of integration, and present evidence of a widening divide between Core and Periphery. Through the comparison in terms of β convergence between the 12 Eurozone countries (EMU-12)[3] and the remaining 15 European Union

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1 Austria, Belgium, Finland, France, Germany, Luxembourg and the Netherlands.

2 Greece, Ireland, Italy, Portugal and Spain.

3 The EMU-12 countries are: Austria (AT), Belgium (BE), Finland (FI), France (FR), Germany (DE), Ireland (IE), Italy (IT), Luxembourg (LU), the Netherlands (NL), Portugal (PT), Spain (ES) and Greece (GR), which joined in 2001. Six more countries have subsequently joined the EMU: Slovenia (2007), Cyprus (2008), Malta (2008), Slovakia (2009), Estonia (2011) and Latvia (2014).

Max Guderzo and Andrea Bosco (edited by), *A Monetary Hope for Europe: the Euro and the Struggle for the Creation of a New Global Currency* ISBN 978-88-6655-965-8 (print) ISBN 978-88-6655-966-5 (online)

countries (other-EU)[4], section 3 shows that the monetary integration process, which started after the completion of the single market in 1993, has not accelerated the catching-up by the Peripheral EMU countries, as *per capita* GDP convergence has happened among the EU-27 but not among the Eurozone countries. In section 4, we analyse the fiscal policy of stabilization by the governments involved in the monetary integration process. Our estimates indicate that in the EMU countries the absorption through the tax and transfer systems of national permanent shocks *vis-à-vis* the EMU-average GDP has been negligible. In section 5 we point to the weaknesses in the EMU institutional design to explain why the fiscal policy of stabilization failed to prompt real convergence within the Eurozone. The macroeconomic guidelines dictated by the European Commission have imposed rigid constraints upon public deficits and debts – from the Maastricht criteria set in 1991 to the Stability and Growth Pact (SGP) introduced in 1998 and then emended and strengthened – thus putting an end to discretionary fiscal impulses[5]. Section 6 concludes by stressing the need for more institutional coordination within the Eurozone through the fiscal union and the banking union complementing the monetary union.

2. Assessing conditions for the optimality of the European currency area

As early as in 1961, Robert Mundell warned that the loss of the exchange rate policy instrument would have resulted in an overwhelming problem for a country joining a currency area. The Nobel Prize 1999 highlighted the difficult task to cope with a high exposure to asymmetric shocks for a country where labour market flexibility was prevented by employment and real wage rigidity. For a country belonging to the fixed exchange rate agreement of the European Monetary System (EMS)[6], the recovery of competitiveness through the adjustment of bilateral parities was severely limited. The completion of the liberalization of capital movements magnified the exposure to speculative attacks, making virtually impossible for EMS countries to face a loss of credibility in the commitment to defend their fixed parities. Once aware of the 'impossible triplet' (free capital markets,

[4] The fifteen remaining countries (other-EU) are those opting-out the monetary union: Denmark (DK), Sweden (SE) and the United Kingdom (UK) and the newcomers: Bulgaria (BG), Czech Republic (CZ), Cyprus (CY), Estonia (EE), Hungary (HU), Latvia (LV), Lithuania (LT), Malta (MT), Poland (PL), Romania (RO), Slovakia (SK) and Slovenia (SI).

[5] Furthermore, the Fiscal Compact, signed by the EMU countries in 2012, entails the quasi-automatic sanctioning of non-compliance or failure to carry on the abatement of the public debt exceeding the 60% of GDP through a 20-years plan of surpluses in the public budget.

[6] The EMS was the fixed but adjustable exchange rates agreement in place from 1979 to 1999 when the EMU started.

fixed exchange rates, monetary policy autonomy), most EMS countries agreed on the start of the monetary unification process.

Let us adapt to the EMU the framework that Mundell (1961) set up for analysing conditions for a common currency to be optimal for a group of sovereign countries.

Figure 1 sketches a continuous OCA line. In all points of the OCA line the costs and benefits of a monetary union just balance, whereas points above it signal that the benefits of entering a common currency exceed costs and points below it that keeping the national currency is more advantageous. The continuous line is determined by a combination of the degree of symmetry (on the vertical axis) i.e. the probability of a country to be hit by an asymmetric shock (depending on the overall efficiency of the economic system) and the degree of economic integration (on the horizontal axis). The negative slope indicates that any decline in the degree of symmetry – i.e. a higher probability of asymmetric shocks (e.g. the exposure to harsher price competition after the end of competitive devaluation) – has to be offset by a higher level of integration to avoid a country falling below the OCA line. Economic integration improves only in the medium term, delivering substantial benefits in the long run. An exogenous factor is then needed in the short run to restore a country's advantage in participating in a monetary union. A real depreciation is one among possible antidotes against a rise in the exposure to a negative shock. This market adjustment, which has the effect to compensate for a negative shock by moving the OCA line downwards, stems from a lowering in unit labour costs (so that the wage dynamics goes below the productivity dynamics). This result will be produced by a higher degree of labour market flexibility[7]. Given the degree of symmetry, the degree of economic integration will be again sufficiently large for the optimality of the currency area to be fulfilled, so that the country remains above the OCA line. In the opposite case, that is when conditions for the optimality of the currency area are not fulfilled, the country will fall below the OCA line[8].

7 After a decentralized system of labour contracts is bound to lower the wage level, heading to a higher unemployment-elasticity of the nominal wage rate and/or reformed institutions of social protection (e.g. weaker regulatory constraints on firing workers).

8 The same effect of restoring the excess of benefits over costs for participating in a currency union will result in case the 'quantity' instead of the 'price' of labour adjusts. Were a country unable to reduce the rigidity of the labour market, the market adjustment might take place through the labour mobility across member countries, which by definition cancels out the unemployment cost. As well known, labour mobility is sufficiently high across the States in the federation of the United States, while is hindered in Europe by linguistic and cultural reasons.

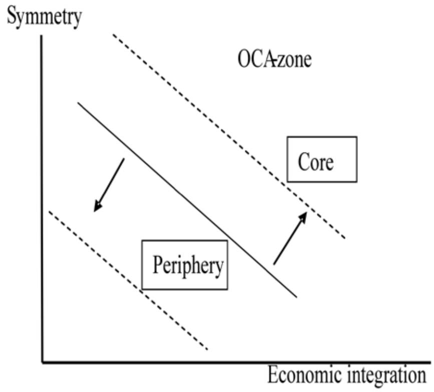

Figure 1 – The OCA line.

The two dotted lines in Figure 1 represent the two opposite – downward or upward – possible developments within the Eurozone. Following an assumption often made in the literature, it is assumed that at the inception of the EMU only the group of the Core countries was located in the 'OCA zone'. The sharing of a common currency was expected to promote – through more product market flexibility and price convergence – a higher degree of economic integration, as the boost to the synchronization of business cycles would have increased the benefits of the common currency[9]. The 'endogeneity of OCA' effect (Frankel, Rose 1998; De Grauwe, Mongelli 2005) can be portrayed in Figure 1 by a downward shift of the OCA line, that is the progressive increase in benefits as the 'dividend' expected *ex post* from the participation in the currency area.

The evaluation of developments in the degree of symmetry within the Eurozone is a complex issue, also considering that a significant increase in intra-EMU trade had already been achieved before 1999.

Krugman (1991, 1993) put forward the view that an economic and monetary integration process points to higher inter-industry specialization. The main drivers of specialization are economies of scale and agglomeration factors, prompting a lower degree of symmetry of GDP fluctuations across countries, and higher exposure of countries to asymmetric shocks, which make *per capita* GDP growth rates across countries diverge. Kalemli-Ozcan, Sorensen and Yosha (2003) complemented this view by adding possible de-

[9] Sharing a currency is expected to promote economic integration through higher product market flexibility and price convergence; the ensuing rise in the symmetry of shocks and in the synchronization of business cycles will increase the benefits of the common currency.

velopments in the financial sector. More liquid credit and capital markets after financial integration could function as a signal of stronger risk-sharing, heading to lower uncertainty on the profitability of investment projects. In fact, an important impulse to the endogenous creation of insurance against asymmetric shocks was expected from integration in financial markets and cross-border mergers among banks, which enormously improved the liquidity and cost conditions for the financing of investment projects. The most noticeable confirmation of this view was offered by the huge expansion of credit creation which took place in Ireland and Spain before the burst of the financial crisis with the Lehman Brothers bankruptcy in September 2008. In these countries, the copious availability of cross-border inter-bank financing and the more financially diversified portfolios of European investors, along with very low or even negative real interest rates[10], boosted the *per capita* income growth *vis-à-vis* the rest of the Eurozone[11]. A trend towards more specialization points to the effect opposite to the 'endogeneity of OCA' view, which is reflected in Figure 1 by the upward shifting of the continuous OCA line.

On the contrary, according to the rationale put forward by McKinnon (1963) and by Kenen (1969), an economic integration process is expected to promote the fulfilment of the OCA conditions. As for the first, a boost to intra-EMU trade prompted by the monetary union should deliver the harmonization of Periphery business cycles with the Core's ones, so decreasing the probability of asymmetric shocks. A survey study based on a gravity model suggests that the impact of the EMU on trade reminds more of a unilateral move towards multilateral openness rather than the participation in a customs union. In fact, the switch to the common currency brings about an increase in bilateral intra-EMU trade by 4%-10% and in bilateral world trade with non-EMU countries by 8%-16% (Micco *et al.* 2003). As for the second, a higher financial integration following the switch to the common currency improves the correlation across demand shocks, which in turn increases product diversification as a shield against asymmetric shocks. Since the increase in openness should bring about a reduction in inter-industry specialization, trade integration and sectoral diversification are factors favouring the optimality of a currency area that

10 The ECB's reaction function derives from the Taylor rule, in which the deviation of inflation from target is measured on the EMU-average, which entails a lower real interest rate for higher than EMU-average inflation countries.

11 Ireland and Spain started accumulating trade deficits, due to the increase in imports more than to nominal rigidities causing a competitiveness loss (European Commission 2009). This is shown by a flexible labour market and fiscal competition boosting exports in the former country, and by labour market reforms leading to a huge increase in temporary jobs in the latter country. In addition, the recourse to tax competition has been shielding Ireland's share of intra-EMU trade.

are likely to mutually reinforce. Empirical evidence shows that the rise in intra-EMU trade is triggering more closeness among productive structures (Alvarez Lopez, Myro Sanchez 2005).

However, as anticipated by Mundell (1961) theoretical analysis of conditions for the optimality of a currency area, the two main institutional changes in Europe – the free circulation of capitals (1990) and the completion of the single market (1993) – did not represent a substitute for exchange rate flexibility. The delayed correction of the Peripheral countries' real divergence *vis-à-vis* Germany through the realignment of the EMS bilateral parities had been effective in slowing down the competitiveness, but from 1990 onwards capital markets' liberalization made currency devaluations impossible, which prompted the move towards a monetary union. However, the comparison between Figure 2.a and Figure 2.b indicates that the divide across the unit labour costs (ULC) of the very heterogeneous European countries has enlarged after the switch to the common currency. The Peripheral countries suffered during the 2000s from an increasing divergence as for the REER measured by ULC *vis-à-vis* the EMU-12 average. On the contrary, Germany – a country that succeeded in pursuing both wage moderation and a steady growth path of total factor productivity (TFP) – exhibits an impressive downward path of the REER up to 2007 and subsequently keeps that level. The increasing divide between Core and Periphery after twelve years of the Eurozone highlights the analytical framework by Mundell (1961) that correctly forecasted the serious impact of the end of devaluations on the less efficient productive systems.

The three possible substitutes for the loss of exchange rate flexibility posed by Mundell I – the viability of internal devaluation, labour mobility and fiscal union – were not in place at the inception of the EMU. Yet, Mundell (1973) revised his previous sceptical view by pointing to the end of the expected decay of the *home bias* in the portfolios of savers and banking institutions after the capital movements' liberalization. Provided that the single currency could succeed in fostering more interconnected European credit and financial markets, cross-border financing and portfolio diversification cancel out the disproportionate concentration of the ownership of equity and government bonds at the Member States' level. According to the so-called Mundell II view, a move towards full financial integration within a currency area magnifies diversification across companies and countries of financial assets in the investors' portfolios. This market risk-sharing should warrant the income and consumption smoothing across upward and downward business cycles. Since capital gains on corporate equities of countries in expansion will compensate for capital losses on the corporate equities of countries in recession, the degree of asymmetry should fall bringing the Eurozone closer to optimality (which in Figure 1 corresponds to a downward movement of the continuous OCA line).

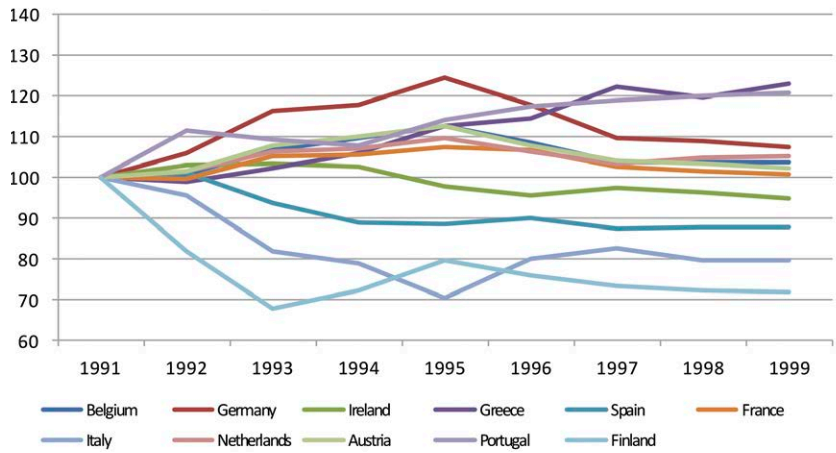

Figure 2A – REER based on relative ULC. Source: Own calculations on Ameco database.

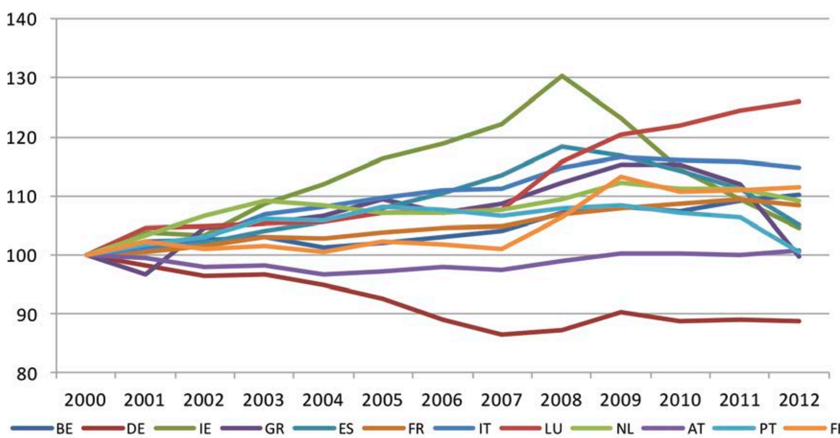

Figure 2B – REER based on relative ULC. Source: Own calculations on Ameco database.

Unfortunately, portfolio diversification across financial assets after the switch to the common currency did not deliver an efficient and lasting risk-sharing of national asymmetric shocks. The rapid process of financial integration, through the merging of banks and financial markets and the abundant liquidity at a very low interest rates, mainly coming from the Core and flooding in the Periphery, permitted in some Peripheral economies the excess investment with respect to private savings, but did not bring about a lasting catching-up process. Following the fall in nominal interest rates, the 'one size fits all' promised by the common monetary policy did not come true. Far from fostering inter-industry specialization, the stronger financial integration within the Eurozone promoted a GDP expansion concentrated in traditional sectors, especially in Ireland and Spain. In these high-inflation countries, the moral hazard triggered in credit markets by the excessive reduction of real interest rates caused the huge capital inflows to finance speculative rallies in housing and financial markets, thus worsening the trade balance through a rapid increase in imported consumption goods (Giavazzi, Spaventa 2010). The subsequent burst of the financial crisis in 2008 provoked the re-nationalization of the portfolios of financial assets, so that real divergence eventually widened between the Core and the Peripheral countries (Croci Angelini, Farina 2012). Therefore, the Mundell II prediction that financial integration would have fostered *per capita* GDP convergence has been disproved.

Since the medium-term furthering of economic integration did not deliver real convergence by the laggard economies, let us turn to the evaluation of labour market flexibility. An important indicator, the steepness of the Phillips curve, is not dissimilar in countries where either the employment protection legislation (EPL) or the real wage rigidity (RWR) have decreased *vis-à-vis* countries where both unemployment and real wage exhibit flexibility (Abbritti, Weber 2010)[12]. Some labour market developments have occurred both in the Periphery and in the Core: (i) the diffusion of temporary contracts reducing unemployment rigidity in Italy and Spain; (ii) the incentives for firms and unions to pursue wage moderation deployed by the German government after the switch to the euro, so that this country's competitiveness has benefitted from real depreciation and its intra-EMU-12 exports have been boosted (Boysen-Hogrefe *et al.* 2010). However, after fifteen years of monetary union, the Periphery is further away from catching-up with the Core than in 1999. Labour market flexibility as the short-run remedy to excessive exposure to asymmetric shocks does not seem to be such to compensate for the higher degree of asymmetry of Peripheral countries, as institutional factors determining RWR prevented a robust rise of labour demand after a negative shock. A major structural change would have occurred only in case both a reduction in EPL and a rise in unemployment benefits (UB) had occurred at the same time. All in all, empirical evidence confirms the finding by Nickell *et al.* (2005) that the problem of the insiders-outsiders divide in the labour market is the most important cause of a mismatch between labour demand and supply.

The monetary union by no means did set a more levelled playing field for *per capita* GDP convergence among 'backward' and 'advanced' countries. As shown in Figure 2.b, in Peripheral countries the path of ULC continuously rose above the EMU-12 average, thus causing a competitiveness loss leading to a fall in exports. The continuous increases in public consumption also

[12] In the literature, the reserve wage of the unemployed, which triggers the degree of RWR, is traced back to the levels of UB and minimum wage, as well as to EPL, a high union density and the centralization of wage negotiations.

contributed to the current account deficits (European Commission 2010). In Portugal and Greece the dynamics of wages largely exceeded the dynamics of a sluggish labour productivity, until the recession following the financial crisis provoked the reversal of the upward ULC trend. Spain and Italy have been suffering from a structural brake off in productivity growth, which caused a ULC rise disproportioned with respect to wage increases, and slowed down exports thereby severely hindering growth rates. In particular, the Greek macroeconomic situation was aggravated by too long a delayed fiscal retrenchment. After the financial crisis provoked the huge increase in the spread on Greek sovereign bonds, the government was obliged by negative growth in 2009-2010 to cut public and private wages. As witnessed by the huge decline in ULC, in 2010 a relevant wage and price deflation was started by Greece, aimed to avoid a further fall in the employment and the income levels. The public money put in banks distressed by the financial crisis, and the credit crunch contributing to the huge fall in GDP growth during the subsequent Great Recession, generated an enormous increase in the public debt / GDP ratios in Greece, Ireland and Portugal, with rocketing spreads *vis-à-vis* the German ten-years Bund. A contagion effect damaged government credibility in Italy and Spain, which in 2011-2012 also suffered a huge rise in the spread on public bonds.

3. The *per capita* GDP convergence within the EMU and the non-EMU economies

The theoretical rationale ruling on the integration process within the institutional framework of the European Union has been represented by the New Classical Economics, pointing to unfettered product and labour markets and to the abolishment of any separation between commercial and investment banks in deregulated credit and financial markets. The progressive demise of tariff barriers and internal market regulations would have liberated market forces in a fully competitive environment. The complete reliance on the power of competitive markets to attain further efficiency in productive systems, and on the capacity of capital market liberalization to provide the funding for investment fostering convergence with the most advanced countries, asked for policy instruments aimed at preventing that a harsher competition in the European markets could weaken the efforts to catch-up by the laggard economies, or even increase divergence. The renounce to consider macroeconomic governance as an important policy instrument to foster convergence left the Structural and Cohesion Funds devised by the European Commission as the only institutional strategy promoting development in backward Member States and regions.

Therefore, the dominance of the neo-classical and monetarist theories caused the operation of deregulated real and financial markets to develop within a very limited institutional framework. These orthodox theoretical approaches nicely complemented the celebrated neo-classical growth model

(Solow 1956), whereby the low-*per-capita*-income economies, with initial lower capital-labour ratio and under the assumption of diminishing returns, were expected to expand at a pace faster than the high-*per-capita*-income economies, and eventually to catch-up in the long run. A series of positive externalities were expected to stem from the participation in the common currency area. The market forces of backward economies would have taken advantage from lower uncertainty on returns to investment projects and lower nominal interest rate after the annulment of the exchange rate risk, as well as from price transparency and the end of transaction costs in currency exchanges. Moreover, the 'open method of coordination' would have promoted the imitation of the guidelines put forward by the best performers in goods and labour markets deregulation, and a reformed system of the Structural and the Cohesion Funds managed through the budget of the European Union, would have supported market forces in backward regions and States during the catching-up process (Sapir *et al.* 2004)[13].

In Figure 3, the Solovian process of catching-up is broadly reflected by scatter diagram showing the negative correlation between *per capita* income growth rates in 1993-2009 for the EU-27 countries and their initial *per capita* GDP in 1993. After the latest EU enlargements, the advantages of new entrants in terms of production costs, due to labour markets much more flexible (e.g. a decentralized wage setting and a low coverage of collective agreements) than those of the incumbents, speeded up real convergence (European Commission 2012).

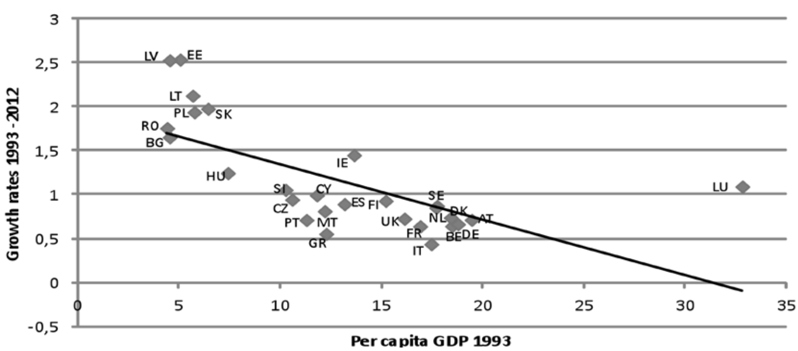

Figure 3 – Per capita GDP beta convergence in EU 27 (PPP). Source: Own calculations on Ameco database.

[13] A large strand of literature also introduced the concept of conditional convergence, whereby idiosyncratic cultural values and different initial economic conditions (e.g. the saving rate, the capital-output ratio) identify clusters of countries, following different growth paths and eventually heading to their own Solovian steady state. This appraisal of convergence, which stresses long-run causes of heterogeneity across countries, is particularly pertinent to the understanding of the wide dispersion across *per capita* GDP in the European Union (Farina 2012).

Figure 4 shows the convergence within the cluster of the EMU-12, whose growth path was influenced by the monetary union and by the common macroeconomic guidelines and constraints on the national fiscal stances. The comparison with the overall convergence across the EU-27 in Figure 3 is striking. The expected convergence across the EMU-12 countries does not emerge, the slope of the β in Figure 4 being positive[14].

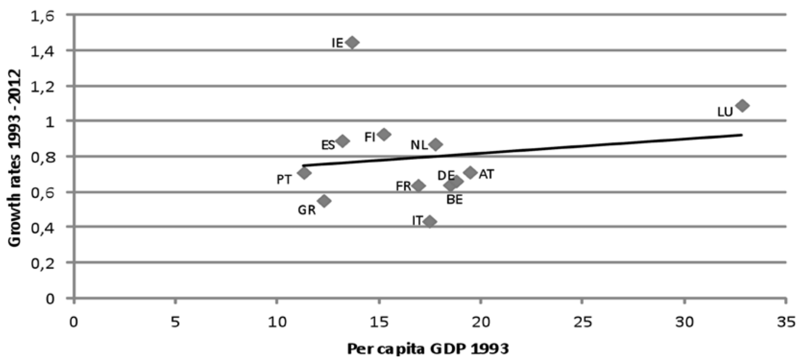

Figure 4 – Per capita GDP beta convergence in EMU 12 (PPP). Source: Own calculations on Ameco database.

Figure 5 shows a pattern of fast convergence among the other-EU economies. The high value of the negative correlation between the initial *per capita* GDP and the subsequent average *per capita* GDP growth rate reflects strong similarities in the productive structures along the shared path of convergence to the more advanced Eurozone economies (Farina, Tamborini 2003). The finding that the slope of the other-EU in Figure 5 is negative, while for the EMU-12 in Figure 4 is positive, underlines that the convergence taking place within the latter countries has been decisive to foster overall GDP β convergence in EU 27. However, the lack of convergence within the EMU-12 countries, which started the monetary integration process, begs an explanation.

[14] It should also be taken into account that the picture is affected by the peculiar growth rate in two outliers, Luxembourg and Ireland. The growth performance of Luxembourg is biased by the disproportionate weight of the financial sector in the GDP, with a huge amount of returns accruing to non-residents. Ireland stands out as the best performer for catching-up within the European integration process. During the 1990s, this country, whose EU membership dates back to 1973, manifested growth rates as high as 6-8 per cent per year, so that its *per capita* income growth rate reached the first positions in the EU ranking. However, the Irish growth performance could be considered an example of successful Solovian convergence up to a point, as it was triggered by fiscal competition.

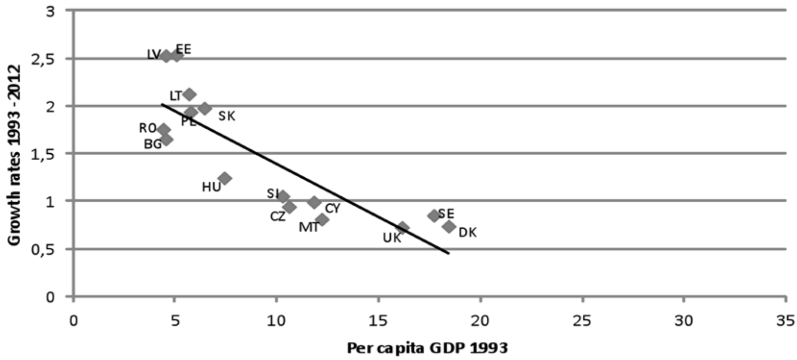

Figure 5 – Per capita GDP beta convergence in other-EU (PPP). Source: Own calculations on Ameco database.

Figure 6 presents the evolution of sigma convergence, i.e. the year by year standard deviation across *per capita* GDP for the EU 27, as well as for EMU-12 and other-EU subgroups. In the period from 1993 to 2008, the standard deviation progressively increases for the EMU-12, while for the other-EU after an initial increase it remains constant on average. The combined evidence of a positive β convergence within the EMU-12 cluster (Figure 4) *vis-à-vis* the steep negative β convergence within the other-EU (Figure 5), and of a rising standard deviation in the EU 27 triggered by the EMU-12 (Figure 6) suggests that the monetary integration process to the single currency has created a widening *per capita* GDP dispersion across the EMU-12 economies up to the financial crisis.

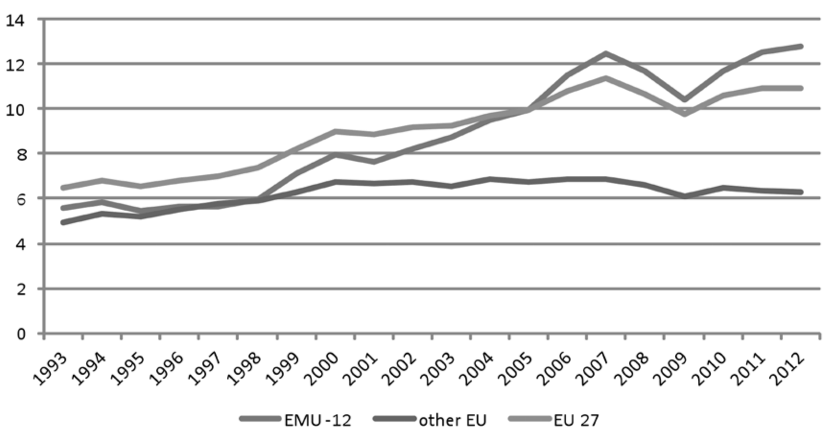

Figure 6 – Per capita GDP sigma convergence in EU 27 (PPP). Source: Own calculations on Ameco database.

4. An estimate of shock absorption through fiscal policy of stabilization within the Eurozone

Within a currency area, the absorption of deviations from the trend *per capita* GDP is performed both by the market adjustment and by the risk-sharing implemented by the centralized fiscal policies of stabilization[15]. In the previous sections, we have shown that labour market flexibiity was not sufficient in the Periphery to compensate for the high exposure of these economies to asymmetric shocks; we also stressed that the roll-back of the financial integration which ensued to the switch to the euro has disproved the Mundell II view that a fast diversification across the investors' portfolios could foster optimality conditions so as to pave the way towards the catching-up by the laggard economies. Also the other two possible substitutes for the loss of exchange rate flexibility are lacking. Labour mobility is not a viable instrument for real convergence in Europe. As for a full-fledged public budget in Brussels, the amount of resources available to the European Commission are very far from the resources needed for the centralization of fiscal policy of stabilization[16].

Hereafter we investigate to what extent fiscal policy of stabilization performed by national governments has been effective in absorbing domestic *per capita* GDP deviations with respect to the EMU-average *per capita* GDP after renouncing the policy instrument of currency devaluation. In our statistical exercise, the degree of absorption by national fiscal policies to be assessed does consist of national business cycle deviations not from the national potential *per capita* GDP but from the EMU-12 average aggregate *per capita* GDP. The aim is to evaluate whether each economic system has been helped by the national fiscal policy of stabilization to reduce its *per capita* GDP distance from the EMU-12 average GDP, or has at least been preserved from further real divergence within the Eurozone as an effect of the exposure to asymmetric shocks in increasingly competitive markets. This exercise is particularly relevant for the evaluation of enduring real divergence after fifteen years of monetary union, as in addition to the absence of a centralized fiscal policy of stabilization the correction of permanent shocks has also been hampered by the fiscal rules imposed by the Stability and Growth Pact (SGP). In fact, for the public deficit / GDP ratio to be balanced in the medium term, national governments had often to resort to pro-cyclical fiscal policies, by implementing restrictive fiscal impulses.

15 According to an empirical study conducted for the United States by Asdrubali *et al.* (1996), shocks to a state GDP were mainly absorbed through capital markets (39%) and credit markets (23%), while the income smoothing through the federal government was very limited (13%).

16 As well-known, the European Commission relies just on a budget of a mere 1% of the EU countries' total GDP.

To cast light on the capacity of national tax and transfer systems to counteract a permanent shock, econometric estimates were conducted for the years 1996-2012 by relying on the revenues and the expenditure structure presently in place in each EMU Member State. The method consists in estimating the relationship between the first differences of *per capita* national income normalized by the *per capita* average income of EMU-12 countries (independent variable) and the same ratio referred to disposable income (the dependent variable) in three different specifications: net of taxes (T); net of taxes and social contributions (T+SC); net of taxes, social contributions and social benefits (T+SC-SB). In other words, the value of GDP, taxes, social contributions and social benefits of each country is weighted for the value of GDP, taxes, social contributions and social benefits of the EMU-12 as a whole.

Regressions have been performed both by imposing the same coefficients to all countries as a pooled panel (see Table 1a) and by specifying individual national coefficients (see Table 1b). In the following equation, the β coefficient expresses the shock persistence after fiscal policy of stabilization. Therefore the difference (1-β) measures the degree to which any shock to national convergence to EMU-12 average has been absorbed by the operation of the national fiscal system.

$$\Delta\left(\frac{Y_i - S_i}{Y_e - S_e}\right)_t = \alpha_i + \beta_i \Delta\left(\frac{Y_i}{Y_e}\right)_t + u_t \qquad (1)$$

We may think of a hypothetical centralized fiscal institution merging the national fiscal impulses of stabilization – implemented through the fiscal system of each country – into a single European budget, and then distributing them across the EMU-12. The use of first differences among these variables, rather than their levels, effectively tackles the endogeneity problem, thus allowing to single out the fiscal stances oriented to counteract *per capita* GDP distance with respect to the EMU-12 average[17]. Only the tax and transfer reshuffling normalized by the EMU-average, aimed at absorbing stochastic shocks is considered, so to eliminate the 'moral hazard' problem connected to the state aid oriented to overcome permanent shocks. This expedient permits to cut off the redistributive function of national public finances from the computation. The different values of the national β coefficients point at different degrees of success in covering national shocks as a function of the size of the initial deviation from the EMU-12 average.

[17] Endogeneity is a loop of causality between the independent and the dependent variables which plagues econometric regressions hindering statistical significance. In our regression model, this problem could arise due to the possible feed-back of the *per capita* GDP on the different measures of national policy of stabilization and is counteracted through the normalization with the EMU-wide data.

Table 1a – Aggregate stabilization in EMU (1996-2012) – pooled panel data model.

	β	t-statistics	p-value	s.e.	R^2
T	1.21802	36.14	0.00000	0.03370	0.88
T+SC	1.23259	32.64	0.00000	0.03776	0.87
T+SC-SB	0.99215	35.60	0.00000	0.02787	0.89

T = Taxes; SC = Social Contributions; SB = Social Benefits

The p-values signal robustness, and the correlation coefficients, are fairly high. As shown by results in Table 1a, aggregate stabilization in the Eurozone, i.e. the degree to which the shocks affecting the EMU-12 as a whole are absorbed, is negligible: the tax plus social contribution minus social benefits specification (the third row) shows almost complete persistence (β = 0,99). As to the tax and the tax plus social contribution specifications (the first two rows), the overall fiscal impulse within the Eurozone resulted in a widening of real divergence (the values of 1-β are negative). Table 1b shows results country by country. In many countries a certain degree of stabilization ($0 < \beta < 1$) applies only in case the fiscal policy fully operates, that is when social benefits are transferred into personal income.

All in all, our econometric estimates indicate that the degree of absorption through stabilization fiscal policy of the deviation of national *per capita* income with respect to the EMU-12 average is rather low also at country level. The shock absorption seems to have slightly improved as an effect of the monetary union, but with much more dispersed degrees of adjustment between the Core and the Periphery.

The largest shock absorption occurs in Spain (in all the three specifications) and in the Netherlands, soon followed by Ireland. The likely explanation is that in these countries the width of fiscal impulses was not hindered by the restrictive impulses imposed by the SGP, due to their relatively low public debt / GDP ratios before the rescue of distressed banks by the government increased the issuing of sovereign bonds and the recession following the financial crisis hit the GDP growth. In many of the other countries, instead, national fiscal policy of stabilization was hampered by the 'snowball effect', the self-aggravating accumulation of public debt, due to the nominal interest exceeding GDP growth causing a severe rise in interest payments. As shown by the persistence – in some cases by the further widening – of *per capita* GDP divergence *vis-à-vis* the EMU-12 average ($\beta > 1$), the need to balance the public budget during recessions, so to stabilize the public debt, caused the restrictive fiscal impulses to be pro-cyclical. In Austria, France, Greece, Luxembourg, and Portugal, fiscal policy of stabilization was not effective in absorbing shocks *vis-à-vis* the EMU-12 average *per capita* GDP in all the three specifications, so that the distance of national *per capita* income even enlarged.

Table 1b – National stabilization in EMU countries (1996-2012).

	β	t-statistics	p-value	s.e.	R^2
Austria					
T	1.61085	4.95	0.00000	0.32542	0.59
T+SC	1.56984	4.76	0.00000	0.32980	0.57
T+SC-SB	1.39438	5.43	0.00000	0.25679	0.63
Belgium					
T	0.93622	3.91	0.00009	0.23944	0.47
T+SC	0.98564	4.10	0.00004	0.24040	0.50
T+SC-SB	0.87724	5.21	0.00000	0.16838	0.62
Finland					
T	1.01805	6.74	0.00000	0.15105	0.73
T+SC	1.03654	6.67	0.00000	0.15540	0.72
T+SC-SB	0.64327	5.03	0.00000	0.12789	0.60
France					
T	1.16414	3.33	0.00086	0.34959	0.39
T+SC	1.23605	3.37	0.00076	0.36678	0.40
T+SC-SB	1.16767	4.40	0.00001	0.26538	0.53
Germany					
T	1.11728	7.00	0.00000	0.15961	0.74
T+SC	1.13948	7.23	0.00000	0.15760	0.75
T+SC-SB	0.83601	7.47	0.00000	0.11192	0.77
Greece					
T	1.23856	15.69	0.00000	0.07894	0.94
T+SC	1.22254	14.68	0.00000	0.08328	0.93
T+SC-SB	1.09821	17.97	0.00000	0.06111	0.95
Ireland					
T	1.11785	19.16	0.00000	0.05834	0.96
T+SC	1.12433	18.84	0.00000	0.05968	0.95
T+SC-SB	0.83516	14.13	0.00000	0.05910	0.91
Italy					
T	0.81483	2.80	0.00504	0.29101	0.32
T+SC	1.11280	3.84	0.00013	0.28966	0.46
T+SC-SB	1.04191	5.47	0.00000	0.19048	0.64

	β	t-statistics	p-value	s.e.	R^2
Luxembourg					
T	1.61734	16.11	0.00000	0.10039	0.94
T+SC	1.64802	16.22	0.00000	0.10160	0.94
T+SC-SB	1.11009	16.95	0.00000	0.06549	0.94
Netherlands					
T	1.01232	4.93	0.00000	0.20534	0.59
T+SC	1.01466	5.04	0.00000	0.20132	0.60
T+SC-SB	0.63091	3.90	0.00010	0.16177	0.47
Portugal					
T	1.15822	7.70	0.00000	0.15042	0.78
T+SC	1.05778	6.86	0.00000	0.15419	0.73
T+SC-SB	1.07928	11.33	0.00000	0.09526	0.88
Spain					
T	0.79867	2.89	0.00379	0.27636	0.33
T+SC	0.80539	2.85	0.00443	0.28259	0.32
T+SC-SB	0.64195	3.10	0.00192	0.20708	0.36

T = Taxes; SC = Social Contributions; SB = Social Benefits

5. The need for institutional reforms

In searching reasons for the failure of the European currency area in fostering convergence among the Core and the Periphery countries, we have analysed both the market adjustment and the absorption of permanent shocks of national *per capita* GDP with respect to the EMU-12 average through national fiscal policy of stabilization. The unsatisfactory results above presented challenge the Mundell (1973) optimistic prediction that the risk-sharing provided by financial integration is a sufficient condition to make a currency area optimal, so to advance real convergence among its Member States.

In this section, we improve on the tenet that the reason for this failure lays in the very weak institutional setting of the Eurozone. First, the capacity of national fiscal stabilization policies has shrunk due to the restrictive macroeconomic policies required for admission to the monetary union and by the SGP constraints (Farina, Ricciuti 2006). Second, the decoupling between savings and investment was interpreted as a signal of financial integration, which would have triggered the catching-up of the backward Peripheral economies (Blanchard, Giavazzi 2002). Quite on the contrary, the financial integration across the Eurozone capital markets prompting more diversified portfolios has been concealing a widening divide between excess savings in the Core and excess domestic demand in the Periphery. Once the financial crisis caused the increase in the public debt / GDP ratios after the rescue of troubled banks, and led banking institutions and financial operators to sell large amounts of the sovereign bonds of distressed Peripheral countries, the trend of capital inflows in the Periphery compensating for the trade deficits was put to an end. In the absence of an ECB endowed with the lender of last resort (LoLR) function and of a full-fledged fiscal union, national governments of the Periphery should have refrained from underestimating the competitiveness problem created by their divergent ULCs *vis-à-vis* the EMU-average, as well as from considering the rise in domestic demand warranted by a large credit creation as an enduring boost to the catching-up process. Third, as an effect of more interconnected banks and capital markets, financial integration has magnified the diffusion of spillovers within the Eurozone. The persistence of heterogeneous conditions of fiscal sustainability within a currency area puts national governments under the constant threat by financial operators since a switch to pessimistic expectations could set in motion a speculative turmoil. In the Eurozone, this is signalled by the strong correlation between Credit Default Swap (CDS) spreads and sovereign bond yields which unfolded across the Peripheral countries Since in fully liberalized capital markets the Eurozone governments depend on the volatile sentiment of financial investors even after the national currency has been renounced, a unification process falling short of including the banking system and the public budgets is at any moment in danger. Fourth, spillovers across countries have also increased as a consequence of heterogeneous institutions, so far as the design of national social protection systems and labour market regulation are considered. The opportunity to exploit potential advantages against competing countries – through capital tax rebate, cuts to the wage wedge, the abolition of job protection, a lower duration of unemployment benefits – has prompted institutional competition in the Eurozone, thus provoking an increasingly un-levelled playing field in the currency area. A country not participating in the 'race to the bottom' will suffer an upward shift in production costs relative to its competitors, so to find itself at disadvantage *vis-à-vis* the other Member States in exploiting amplified trade opportunities following the monetary union. In recent years, many Peripheral countries severely hit by the financial crisis were compelled by the SGP – due to their high public debt and/or as a condition to enter the financial aid programmes organized by the so-called 'Troika' – to engineer hugely restrictive fiscal impulses aimed at restoring fiscal sustainability. While the decay of the competitiveness of many Peripheral countries has required a huge real deflation through the fall of wages and prices, the so-called policy of 'austerity' consisting in large negative fiscal impulses caused a fall in domestic demand, so that the consequent slowdown in the formation of fiscal revenues further endangered the sustainability of public finances.

Therefore, the European process of 'integration without convergence' urges the deployment of more appropriate institutions backing the functioning of market forces. To accomplish the objective to build up an optimal currency area, a macroeconomic governance should have been set up *ex ante*, going beyond the surveillance on national budgetary policies and tight fiscal rules.

There is a string of tightly interlinked questions, the solution of which could give birth to a coherent EMU institutional design pointing to optimality conditions for the currency area. A first question concerns the ECB Statute outlawing the LoLR function, which denies the principle that a central bank is empowered with the prerogative to autonomously create fiat money by virtue of its monetary sovereignty. This weakness magnifies the relevance of the lack of control by an EMU government on the currency in which its public debt is denominated. The motivation behind the prohibition of excessive public deficits and debts over GDP is not just to shield the ECB from a non-receivable bail-out request by a government with uncertain fiscal solvency, but to prevent that financial markets lose confidence in the sustainability of the public finances just as an effect of the absence of the ECB's LoLR function. How relevant is this function has been highlighted by the rapid fall in the spread of the Peripheral countries sovereign bonds after Governor Draghi announced in July 2012 that the ECB was ready to do 'whatever it takes' to defend the euro. The 'quantitative easing' initiatives engineered by the ECB, while more limited than the FED's ones, should not be seen as a substitute for the LoLR function. It is the lack of this function the main reason for the low credibility suffered from Periphery's fiscal sustainability. Had the LoLR function been in the Statute of the ECB, there would have been no need for the funds that the Troika lent to the most distressed countries (Greece, Ireland, Portugal, and Spain) to be conditioned to the 'austerity' measures. The Peripheral countries' fiscal solvency would have been fully warranted, no 'rescue' plans would have been negotiated with the Troika, and the further dampening of the GDP growth would have been avoided.

A second question is the need to establish a Banking Union, so as to avoid that the spread on the public debt issued by a government with low fiscal sustainability could worsen the solvency of banks burdened by Peripheral countries' bonds. The implementation of three essential instruments is in order: (i) the centralization of European banks supervision; (ii) the redemption fund for distressed banks; and (iii) the common guarantee on deposit insurance. The ECB's re-financing operations at 1% interest rate brought about the return to *home bias*, that is a high share of national public debt owned by Periphery's domestic banks, which continue to be exposed to the liquidity and solvency crises of their government's bonds. The establishment of the Banking Union will allow the European Stability Mechanism (ESM) to borrow from the ECB and buy sovereign bonds. However, the interdependence between banks and States cannot be solved by the Bank Union alone. The 're-nationalization' of sovereign debt demonstrates that the purchase of sovereign bonds in the primary market by the ESM – a substitute for the ECB's 'last resort' function – could not be trusted by investors as an invulnerable shield for the euro. Since the 'flight to quality' of the Core countries' banks ensuing the financial crisis put an end to the cross-border interconnections between banks and governments, the roll-back of the European financial integration has become a new threat to solvency of banking institutions and to the credibility of the Eurozone. To be credible, the planned resolution fund should be complemented by a common fiscal backstop. The Banking Union could prevent the Eurozone from being exposed to possible solvency crises hitting Peripheral governments only in the case that the Core countries would agree on the issuing of Eurobonds with the mutual guarantee of all Eurozone's governments.

Therefore, the third question – the need for fiscal institutions of mutual risk-sharing – stands out as the most fundamental one. In the XIX century, after that in 1790 the Federal government of the United States bailed out some States of the federation, they autonomously adopted balanced-budget rules. The institutional design of fiscal federalism, whereby the federal government organizes a system of mutual risk-sharing (the States in recession through the federal budget receive transfers which are funded by the States in expansion), was complemented by the nationalization of the debt of States in default. In today's Europe, the decision to avoid the 'moral hazard' of large redistributive transfers across the EMU countries has suggested the opposite arrangement, whereby the constraint of SGP fiscal rules on national governments has not been complemented by the centralized organization of mutual risk-sharing. As above pointed up, this loose approach to fiscal policy coordination has been unable to foster convergence and to tackle the negative impact on GDP growth caused by the twist towards restriction imposed by the Eurozone institutions on the governments' fiscal stances.

6. Concluding remarks

The economic and monetary integration processes taking place in Europe in the last decades did not favour the catching-up of less advanced countries, thus hindering the path of the Periphery to satisfying the optimality conditions for a currency area. Differently from the 'endogeneity of OCA' view, the formation of a monetary union did not *per se* facilitate the participating countries in *ex post* compliance with the OCA criteria. The empirical evidence offered in the paper indicates that within the Eurozone the *per capita* GDP convergence is thwarted by both the limited magnitude of the market adjustment – with the less advanced Peripheral economies exhibiting real divergence as measured by ULC – and the insufficient capacity of national fiscal policy of stabilization to annul temporary GDP deviations from the EMU-average GDP. Furthermore, the financial crisis even prompted the 're-nationalization' of the public debt, thus procrastinating the hike in the degree of risk on sovereign debt.

As for the market adjustment mechanism, the comparison between the β convergence for EMU-12 and for the other-EU countries has indicated the absence of *per capita* GDP convergence within the Eurozone. Since after the end of currency devaluations the national productive systems of the EMU Peripheral countries proved unable to cope with the efficiency divide *vis-à-vis* the Core, the convergence process has been mainly carried out in the European Union by the catching-up of the enlargement economies. As for fiscal policy tackling permanent shocks *vis-à-vis* the EMU-12 average GDP, our econometric exercise has measured the impact on *per capita* GDP convergence of the centralized fiscal policies of stabilization that would be adopted in a hypothetical Fiscal Union (while retaining the functioning of national tax and transfer system of the EMU countries, that is without forcing any kind of harmonization of fiscal stances across national fiscal systems). The shock absorption through the tax and transfer systems turned out to be extremely low, and in many cases the distance from the EMU-average GDP widened. This finding is a hint that the choice to centralize the monitoring and sanctioning of public finances, while preserving subsidiarity in budgetary policies, is bound to be reformed. Since the Maastricht Treaty the restrictive fiscal rules imposed on Eurozone's governments have hampered the capacity of public budgets to accompany the real convergence process within the Eurozone. After the financial crisis, the 'austerity' policies implemented by the EMU governments during the Great Recession have negatively impinged on GDP growth.

The Mundell recipe for the optimality of a currency area states that an internal devaluation, labour mobility and a fiscal union are on an equal basis substitutes for the loss of exchange rate flexibility. Yet, in the present macroeconomic conditions of the Eurozone the first two policy instruments are not operating: the lowering of domestic wages and prices could worsen deflation, and larger migration flows within the EMU could lead to factor misallocation across heterogeneous productive systems. To avoid a possible *break-up* of the Eurozone, the most promising strategy is an agreement on a fully-fledged federal budget. The so-called 'Transfer Union', that is the cross-states redistribution which would be needed to cope with the permanent shocks which prevent the Peripheral countries from catching-up, cannot be unanimously agreed on and has to be excluded. Yet, after the failure of the 'austerity' to restore GDP growth in the distressed Peripheral countries, the need for the recovery of fiscal sustainability has to be reconciled with the objective to orient fiscal policy of stabilization to foster real convergence. A Fiscal Union with a budget corresponding to 5-10% of the overall GDP, funded through a common tax levied at the Member State level, could organize a mutual risk-sharing delivering monetary transfers to Member States whose GDP variation is below the EMU-average variation, thus contributing to the recovery of the catching-up process.

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The European Banking Union: The Last Building Block towards a New EMU?

Fritz Breuss

1. Introduction

The ongoing euro crisis is the result of at least three interacting factors: a current account crisis (different competitiveness of Eurozone members), a sovereign debt crisis and a banking crisis. The euro crisis was preceded by the global financial and economic crisis (GFC) in 2008-09, which in turn had its origin in the United States when the housing bubble burst and many systemically important banks plunged into the abyss. The bankruptcy of the Lehman Brothers investment bank on 15 September 2008 sparked an international banking crisis, because the interbank market virtually collapsed and stopped lending to the real sector. In addition, the three causes of the crisis in the Eurozone increased (especially in the peripheral countries) so intensely following the GFC that in early 2010 it sparked the so-called euro crisis (not crisis of the euro). Already five Eurozone members – especially in the periphery – are in one way or another under the euro rescue umbrella. The causes vary. Greece would have gone bankrupt without euro rescue as a result of its debt. In Ireland, the bursting of the housing bubble led to a crisis of the banking system and, after the nationalization of banks, to a sovereign debt crisis. In Portugal, the GFC led to a sovereign debt crisis. In Spain – as in Ireland – the real estate boom was fatal for the banking sector. In Cyprus the banks pulled the country into crisis. All the problem countries of the Eurozone (except Ireland) have the common feature that their competitiveness against the core of the Eurozone has been falling for years, thereby building up macroeconomic imbalances (especially in the current account). Following the strict recovery and reform requirements of the so-called 'Troika' (experts of the EU Commission, the ECB and the IMF), these imbalances have decreased again, but the peripheral countries slipped into a deep recession (with sharply rising unemployment), from which they are recovering only slowly.

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It should be noted that the United States, after triggering the GFC, mastered both the 'Great Recession' in 2009 (real GDP −3.1%) and the recovery since then better than Europe (−4.3% EU, Eurozone −4.4%). While in 2012 and 2013 the Eurozone slid again into a (double-dip) recession, the economy of the US picked up, albeit slowly. Unlike the Eurozone, the US already has an effectively operating monetary union. Obviously the US is able to resolve economic crises which have their origin in the banking sphere better and more flexibly. In the EU, the crises have relentlessly disclosed the weaknesses of the economic structure of the Economic and Monetary Union (EMU). Since the outbreak of the euro crisis representatives of the EU have been eagerly trying to close these gaps. Through the new economic architecture (New Economic Governance) of the 'six-pack' (reform of the Stability and Growth Pact and surveillance of macroeconomic imbalances; fiscal pact; Euro Plus Pact, 'two-pack') the EU/Eurozone intends to get a grip on at least two of the causes of the crisis: debt and current account crisis (Breuss 2013). A stabilization of the banking sector, aimed at preventing future banking crises, is to be achieved through the creation of a European Banking Union (EBU). The latter would also be a further step closer to completing the internal market.

2. Problem areas of the European banking sector

2.1 The burden of non-performing loans

Since the outbreak of the GFC in 2008-09 the number and volume of 'bad' or 'non-performing loans' (NPL) increased greatly, especially in the peripheral countries (Greece, Ireland, Italy, Portugal and Spain) (German Council of Economic Experts 2012: 157; European Commission 2013c). A study by Ernst & Young (2012) also points in this direction. According to their estimates the volume of 'bad loans' in the Eurozone increased in 2013 to 918 billion euros (an increase of 80 billion euros in one year). This corresponds to 9.5% of GDP in the Eurozone. The share of 'bad loans' to total assets is highest in Spain (15.5%) and Italy (10.2%) and low in Germany (2.7%). In the Eurozone it is on average 7.6%, according to data from 'Bank Watch' (2013: 1). The share of NPLs in total loans was highest in non-euro area countries such as Bulgaria (18%) and Hungary (16%). These are followed by Greece with 15.8% and Cyprus with 14%. In the EU-27 this share was on average only 4% (Germany 2%, Austria and France each 4%). The Bank for International Settlement (BIS 2013:12) also stresses the problems of NPL in Europe. Whereas the share of non-performing loans trended up after 2008 in the euro area, it subsided after 2009 in the United States.

2.2 Overbanking in small Eurozone countries

The Cyprus crisis has dramatically shown that some (small) euro area Member States have an overly large banking sector (Allen *et al.* 2011; Beck 2012;

European Commission 2013c; Liikanen Report 2012: 13). In addition, some of these countries had a business model restricted to the banking sector alone, which made them extremely vulnerable during the GFC in 2008-09 and the subsequent euro crisis. According to ECB sources, in 2013 the share of bank assets to GDP in Luxembourg amounted to 2100%, 770% in Malta, 634% in Ireland and 614% in Cyprus, as opposed to 482% in Switzerland, 296% in Austria and 142% in Slovenia. Conversely, the corresponding proportion in large EU countries was fairly modest: 502% in the UK, 291% in Germany and a mere 91% in the US.

2.3 Tight-mesh interbank network in Europe

The European banking system features intensive linkages that entail the risk of spillovers and contagion in the case of banking crises. Although cross-border banking (assets and liabilities) is characterized by a 'neighbourhood effect' (i.e. German banks trade more with customers/banks in neighbouring countries such as France and *vice versa*; banks in Belgium do business with banks in the Netherlands etc.), at the same time there is also a strong 'bias' towards Britain. In view of the prominent role of London as an international financial centre, cross-border banking business with Britain is more intense than with the neighbourhood shops. Germany's banking business with the UK accounts for 23.6%, whereas with the closest neighbours in France it is only 7.8%, and 2.4% with Switzerland (24.7% with US banks). Other Eurozone banks reveal similar figures. Even the share of business of US banks with the UK amounts to 34% of their total cross-border bank transactions (Tonzer 2013: 39).

2.4 Eurozone periphery banks require manifold adaptation

In its global financial stability report the IMF (2013a: 17) concluded that the peripheral countries of the euro area (Greece, Ireland, Italy, Portugal and Spain) have the worst scores in the ranking of the banking systems of the euro area and therefore need massive adjustment (see also Ferber 2013). This verdict is based on four bank balance sheet indicators – loss absorption capacity: bank buffers ratio (Basel III: 8%); asset quality: change in impaired loan ratio (share of NPLs); funding: loan-to-deposit ratio; profitability: return on assets.

At first glance the European banking sector is not as fit as that of the United States. According to Vítor Constâncio, the Vice-President of the European Central Bank («Financial Times», 1 October 2013), Europe's banks are just as strong as US rivals and are being unjustly undervalued by investors. Whereas the profitability of European banks is still subdued, even six years after the Subprime crisis and Lehman Brothers crash, US banks appear to be in rude health. It seems that there are three factors distorting the picture (Szalay 2013: 21): (i) a different role of the banking sector in the real economy (in Europe bank assets amount to 270% of GDP, in the US only 70%; non-financial enterprises are financed by over 50% via bank credits in Europe, whereas this ratio is only 20% in the US); (ii) shadow banking (hedge funds etc.) plays a much bigger role in the US than in Europe. The balance sheets are relieved primarily because of the prominent role of the major mortgage lenders Freddie Mac and Fannie Mae; (iii) there are differences in the evaluation of balance sheets. Whereas the US banks publish only net positions according to the US-GAAP system, in Europe banks must evaluate according to a gross principle (IFRS).

2.5 Vicious circle between banks and sovereigns

During the 'Great Recession' and in the following 'euro crisis' the European States played the role of the 'lender of last resort' causing high public debt through bank bailouts. According to recent data from Eurostat (Baciulis 2013), since the onset of the GFC in 2008-2009 government intervention to repair the banking sector has reached dramatic proportions. Government stimulus measures take different forms (direct aid with participation capital, monetary policy operations, overall fiscal support measures and the nationalization of banks). The net cost of the bank bailout programmes (where the State played the role of lender of last resort) are reflected in a cumulative increase in the national debt by 2012 to 690 billion euros in EU-27 (or 5.2% of GDP) and around 520 billion euro in the Eurozone (or 5.5% of GDP). They increased the budget deficit of the EU-27 by 0.5% of GDP in 2010 (peak) and in 2012 still amounted to 0.4% (0.7% in the euro area and 0.6% respectively). In Ireland the share of the deficit increase was greatest in 2010, due to the nationalization of banks: the overall deficit was 30%, including 20% of GDP from bank nationalization. In Portugal, the budget deficit in 2010 rose to 10% of GDP, the share of bank rescue was relatively low at 1%. In 2012, the contribution of the bank bailout in Greece (and hence an increase of the budget deficit) was particularly large at 4 percentage points of GDP, followed by Spain with 3.6 percentage points. In other EU countries (Belgium, Latvia, Austria, Portugal and Cyprus – not counting the bailout of March 2013), the cost of the bank bailout increased the budget deficit by 0.2 percentage points. These capital injections were treated by Eurostat as deficit-increasing capital transfers (government expenditure) and not as financial transactions (acquisition of equity), since they were assessed to be covering losses. Nevertheless, all capital injections, whether they are treated as government expenditure or as acquisition of equity, generally affect government debt since governments have to finance them.

2.6 Delayed bank reform dims growth prospects for the Eurozone

According to the IMF (2013b) the still slow implementation of financial sector reform is one of the main reasons for the much weaker recovery from the 'Great Recession' in 2009 compared to the United States. Whereas the EU/

Eurozone drifted into a 'double-dip' recession in 2013, the US economy has been on a continuing recovery path since 2009 (see the forecasts by the European Commission 2013a; and the OECD 2013). In the medium term too, growth prospects are much weaker for Europe than for the United States (IMF 2013b).

3. Time for reregulation after the financial crisis

3.1 G20 international reform efforts

Shortly after the Lehman collapse, the G20 meeting in Washington on 15 November 2008 had already identified the main problems of the international banking system: (1) 'Too Big to Fail': the States (taxpayers) had to act as a 'lender of last resort' to stand straight to avoid further bank failures. This inevitably led to sovereign debt crises. Banks which are too big and systemically important could practically blackmail the States. (2) Universal banking system: in 1933, in response to the 'Great Depression', the Glass-Steagall Act was introduced. It was a two-tier banking system: investment banking was separated from normal banking business. It was only under President Bill Clinton in 1999 that this scheme was abolished in several stages to make way for the universal banking system, which had long been common in Europe.

Since that correct identification of the problems of the international financial sector, which contributed to trigger the GFC in 2008-2009, seven years have elapsed in which new approaches for stabilising the international financial sector have been suggested at international level (G20, G7, OECD, BIS). However, the actual implementation is a lengthy process and the necessary reform steps have not yet been completely achieved. The reason for the delayed reforms may be due to the fact that the whole system has to change: the philosophy of a totally unregulated banking sector up to the GFC in 2008-2009 needs to be reversed. According to the EU Commission President Barroso (2012a), the unregulated financial sector led to 'irresponsible practices' and hence to the global financial crisis.

3.2 Reform steps in major financial centres

In the United States, the reorganization and reform of the banking sector took place more rapidly than in Europe. In the first place, both the resolution of insolvent banks and banking supervision are already subject to long-established rules. Additionally, through the so-called Volcker Rule, announced in 2010, the US government legally intended to reintroduce an attenuated form of the two-tier banking system, a kind of 'Son of Glass-Steagall'. The Volcker Rule prohibits banks from trading on their own account and participating in hedge funds and private equity funds (Lanz 2013b). The complicated and comprehensive provisions of the Volcker Rule were scheduled to be implemented as part of the Dodd-Frank Act on 21 July 2012, with preceding ramifications, but were delayed. The competent agencies then approved regulations implementing the rule, which came into effect on 1 April 2014.

Great Britain, although (still) an EU member, but outside the Eurozone, has attempted to regulate its extensive banking sector itself after the bankruptcy and nationalization of Northern Rock in September 2007. The starting point was the Vickers Commission recommendations, first in 2011 with an interim report and then in a final report in 2013 (Edmonds 2013). These were implemented in the Financial Services (Banking Reform) Act of 2013[1]. As in the US, a kind of 'Son of Glass-Steagall' was introduced by a structural reform which proposed the end of the universal banking system[2]. In July 2013 HM Treasury invited comments on the document 'Banking Reform: Draft Secondary Legislation' proposing four statutory instruments under the Banking Reform Act – ring-fenced bodies and core activities order; excluded activities and prohibition order; banking reform (loss absorbency requirements) order; and fees and prescribed international organizations regulations (HM Treasury 2013). In the wake of the Libor scandal a high-profile parliamentary commission proposed to make responsible bankers criminally liable too («Neue Zürcher Zeitung», 20 June 2013: 27)[3].

In Switzerland, the banking crisis was also relatively well mastered and of the two major banks which were classified as 'Too big to fail' (UBS and Credit Swiss), one introduced stricter capital adequacy requirements than the normal rules of Basel III. In its latest country report (IMF 2013c; Lanz 2013a) the IMF praised the Swiss bank insolvency order, the introduction of 'Basel III' and the 'Too big to fail' (TBTF) legislation. However, the big banks were criticized. The relatively high-risk-weighted capital ratios would stand

1 See the UK Parliament website: <http://services.parliament.uk/bills/2013-14/financialservicesbankingreform.html>.

2 In France, the banking reform was approved by both legislative chambers in July 2013. It stipulates that from 2015 on risky investment activities must be separated from normal customer business («Neue Zürcher Zeitung», 20 July 2013: 26). In Germany too, on 17 May 2013 the German Bundestag decided on a weak form of the two-tier banking system in the context of the decision on the *Law for the protection against risks and to plan the recovery and resolution of credit institutions and financial groups*.

3 On 4 December 2013 the European Commission (<http://ec.europa.eu/competition/publications/weekly_news_summary/2013_12_06.html>) fined 8 international financial institutions a total of EUR 1.71 billion for participating in illegal cartels (LIBOR and EURIBOR scandals) in markets for financial derivatives covering the European Economic Area (EEA) and the Yen market. The penalty consists of EUR 465 million for participating in euro-derivatives and of EUR 260 million for derivatives in Japanese Yen. The fines charged to the 8 banks involved were: Deutsche Bank (EUR 725 million); Société Générale (EUR 446 million); Royal Bank of Scotland (EUR 391 million); JP Morgan; RP Martin and the Citigroup. The British Barclays and the Swiss UBS were not sanctioned because they acted as chief witnesses.

up to a high absolute level of indebtedness. The leverage ratio[4] (Tier 1 – own – capital divided by the bank's average total consolidated assets) at UBS and Credit Suisse is much lower than that of a comparison group of large banks (UBS 2.9%; average of US large banks 4.3%, but Deutsche Bank only 1.93%: see Lanz 2013c). The TBTF legislation requires that large Swiss banks (UBS, CS) must have a risk-weighted equity ratio of 19% and an unweighted equity ratio (leverage ratio of 4.6% by 2018 – Land 2014c).

3.3 A robust financial framework for the EU single market

The global financial and economic crisis (GFC) in 2008-2009 highlighted the need for better regulation and supervision of the financial sector in the EU as well. Since 2010 the European Commission has proposed nearly 30 sets of rules to ensure all financial actors, products and markets are appropriately regulated and efficiently supervised. These rules are the basic framework for all 28 Member States of the EU and underpin a properly functioning single market for financial services (European Commission 2013f). The ensuing euro crisis added an extra dimension, stressing the need for a better governed and more entrenched economic and monetary union if a single currency is to work in the long run (Breuss 2013). In 2011 the crisis took a new turn with the Eurozone debt crisis, highlighting the potentially vicious circle between banks and sovereigns. For that circle to be broken, a European Banking Union (EBU) appeared to be the answer, which is why EU Heads of State and Government committed to a banking union in June 2012 (European Council 2012a). The vision was further developed in the European Commission's blueprint for a deep and genuine economic and monetary union (the 'Barroso plan') in November 2012 (Barroso 2012b). The Heads of State and Government agreed that the legislative work underpinning the EBU should be completed before the end of the legislature (Spring 2014). The necessary legal substructure (regulations and directives) for the 28 EU Member States had to be agreed upon in a 'trialogue' agreement between the Commission, the Council and the European Parliament.

Part of the legal measures to reregulate the financial sector in the EU/euro area are linked to the G20 commitments, including two very significant packages on prudential requirements for banks and the regulation of capital markets (Single Rule Book of prudential requirements for banks: capital, liquidity &

[4] On 12 January 2014 the Basel Committee issued the full text of Basel III's leverage ratio framework and disclosure requirements (BIS 2014) following endorsement by its governing body, the Group of Central Bank Governors and Heads of Supervision (GHOS). Basel III's leverage ratio is defined as the 'capital measure' (the numerator) divided by the 'exposure measure' (the denominator) and is expressed as a percentage. The capital measure is currently defined as Tier 1 capital and the minimum leverage ratio is 3%. This somewhat softened criteria of 3% should apply only as of 2018.

leverage and stricter rules on remuneration and improved tax transparency – 'CRD IV'/'CRR'). Europe has also been working to improve the stability and efficiency of the single market in financial services. This is essential to ensure that the financial sector supports the real economy (European Commission 2013b).

When the financial crisis spread to Europe in 2008, creating a 'Great Recession' in 2009, the EU had 27 different regulatory systems for banks in place, largely based on national rules and national rescue measures. So the pre-crisis framework was incapable of responding to the financial crisis, in particular to its systemic nature. Since 2008 the European Commission has tabled around 30 proposals to create piece-by-piece a sounder and more effective financial sector, hence further completing the single market (European Commission 2013b). The following steps to improve the financial sector in the EU/Eurozone have either already been implemented or are on the agenda for future completion (European Commission 2013f).

3.3.1 Better supervision of the financial system

Three European supervisory authorities (ESAs) were established on 1 January 2011 to introduce a supervisory architecture: the European Banking Authority (EBA) in London, which deals with bank supervision, including supervision of the recapitalization of banks (it also carries out bank stress tests); the European Securities and Markets Authority (ESMA) in Paris, which deals with the supervision of capital markets and performs direct supervision with regard to credit rating agencies and trade repositories; and the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt, which deals with insurance supervision.

The 28 national supervisors are represented in all three supervising authorities. Their role is to contribute to the development of a single rulebook for financial regulation in Europe, solve cross-border problems, prevent the build-up of risks and help restore confidence.

A European Systemic Risk Board (ESRB) located at the ECB was established to monitor and assess potential threats to financial stability that arise from macroeconomic developments and developments within the financial system as a whole ('macro-prudential supervision'). To this end, the ESRB provides an early warning of system-wide risks that may be building up and, where necessary, issues recommendations for action to deal with these risks.

3.3.2 A Single Rulebook for all banks in the EU

The European Council of June 2009 unanimously recommended establishing a 'Single Rulebook' applicable to all financial institutions in the single market (8,300 banks). The rulebook, applicable to all 28 Member States of the EU is a corpus of legislative texts covering all financial actors and products: banks have to comply with one single set of rules across the single market.

This is crucial to ensure that there are no loopholes and effective regulation everywhere in order to guarantee a level playing field for banks and a genuine single market for financial services.

3.3.2.1 Stronger prudential requirements – Basel III implementation

The package on capital requirements for banks, the so called 'CRD IV', which via a Regulation and a Directive transposes the new global standards on bank capital (commonly known as the Basel III agreement) into the EU legal framework, was published in the «EU Official Journal» on 27 June and entered into force on 16 July 2013[5].

The new rules tackle some of the vulnerabilities shown by the banking institutions during the crisis, namely the insufficient level of capital, in terms of both quantity and quality, resulting in the need for unprecedented support from national authorities. The timely implementation of the Basel III agreement[6] features among the commitments made by the EU at the G20.

3.3.2.2 Recast deposit guarantee schemes

A second strand of a more robust financial sector is ensuring that bank deposits in all Member States are guaranteed up to EUR 100,000 per depositor per bank if a bank fails. From a financial stability perspective, this guarantee prevents depositors from making brutal withdrawals from their banks ('bank run'), thereby averting severe economic consequences.

On 17 December 2013 a political agreement was reached between the European Parliament and EU Member States on the new rules on Deposit Guarantee Schemes (DGS; see European Commission 2013g). The DGS Directive[7] will strengthen the existing system of national DGS to respond to

[5] The implementation of 'Basel III' (capital adequacy requirements and liquidity requirements) into EU law is realized by: (1) a banking package (adopted by the European Parliament on 16 April 2013 and by the ECOFIN on 20 June) consisting of a) an equity-Regulation (CRR) and b) the 4th edition of the Capital Requirements Directive (CRD IV, replacing the previous Directives 2006/48 and 2006/49); and (2) a regulation of 'bankers' bonuses' with a 1:1 rule – i.e. bonuses may only be as high as the level of a normal salary. Exceptions (1:2) must be approved by the Board, on condition that either 66% of shareholders owning half the shares agree or there is a 75% majority.

[6] Details on the *International regulatory framework for banks (Basel III)* can be found on the website of the Bank for International Settlements (BIS), Basel: <http://www.bis.org/bcbs/basel3.htm>.

[7] The legal basis of the national DGS is Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (Text with EEA relevance), «Official Journal of the European Union» (OJ), L 68/3, 13 March 2009. It states that by 31 December 2010 the coverage for the aggregate deposits of each depositor should be set at EUR 100,000.

the weaknesses that the financial crisis revealed. Depositors will continue to benefit from a guaranteed coverage of € 100,000 (EU law since December 2010) in case of bankruptcy, but access to the guaranteed amount will be easier and faster. Repayment deadlines will be gradually reduced from the current 20 working days to 7 working days in 2024 (15 working days as from 1 January 2019; 10 working days as from 1 January 2021 and eventually 7 working days as from 1 January 2024). For the first time since the introduction of DGS in 1994, the Directive sets forth financing requirements for DGS. In principle, the target level for *ex ante* funds of DGS is 0.8% of covered deposits to be collected from banks over a 10-year period.

3.3.2.3 A framework for bank recovery and resolution – from 'bail-out' to 'bail-in'

Repeated bailouts of banks have created a situation of profound inequity, increased public debt and imposed a heavy burden on taxpayers (European Commission 2013f). To ensure that the taxpayer will not end up bailing out banks repeatedly, the European Commission proposed a common framework of rules and powers to help EU countries intervene to manage banks in difficulty[8]. Following the agreement by the EU finance ministers in ECOFIN (2013a; see also Barnier 2013) on a common position on the resolution of banks, i.e. dealing with ailing banks, on 27 June 2013, the European Parliament and the Member States reached a ('Trilogue') agreement on this framework (Bank Recovery and Resolution Directive – BRRD) on 11 December 2013, subject to technical finalization and formal approval by both institutions.

The new rules provide authorities with the means to intervene decisively both before problems occur (for instance by ensuring that all banks have recovery and resolution plans in place) and early on in the process if they do (for instance, the power to appoint a temporary administrator in a bank for a limited period to deal with problems). If, despite these preventive measures, the financial situation of a bank deteriorates beyond repair, the new law ensures through a 'bail-in' mechanism (modelled after the bank bailout in Cyprus on 25 March 2013) that shareholders and creditors of the banks have to pay their share. If additional resources are needed, these will be taken from the national, prefunded resolution fund that each Member State will have to establish and build up so that it reaches a level of 1% of covered deposits within 10 years. All banks will have to pay in to these funds, but contribu-

[8] *Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD),* Brussels, COM (2012) 280 final, 2012/0150 (COD). Details concerning the topic of 'recovery and resolution of financial institutions' can be found on the website of the European Commission (The EU Single Market – Crisis Management): <http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#maincontentSec1>.

tions will be higher for banks taking more risks. The BRRD is a law which applies to all 28 EU Member States and constitutes a fundamental step towards the completion of the Banking Union.

The 'bail-in' mechanism in short (European Commission 2013f: 5): if a bank needs to resort to bail-in, authorities will first bail-in all shareholders and will then follow a pre-determined order ('cascade of shareholders'). Shareholders and other creditors who invest in bank capital (such as holders of convertible bonds and junior bonds) will bear losses first. Deposits under EUR 100,000 will never be touched: they are entirely protected at all times via the recast DGS directive. Deposits of individuals and SMEs above EUR 100,000 will (1) benefit from a preferential treatment ('depositor preference') ensuring that they do not suffer any loss before other unsecured creditors (so they are at the very bottom of the bail-in hierarchy) and (2) Member States can choose to use certain flexibilities to exclude them fully.

3.3.3 Other measures of the Single Rulebook

To complement the key pillars of the single rulebook set out above, the Commission has tabled legislation on other aspects to make the financial sector as a whole more robust (European Commission 2013b, 2013f).

The following rules are now in force (a selection of the measures taken): risk-based prudential and solvency rules for insurers ('Solvency II'); strengthened supervision of financial conglomerates; remuneration and prudential requirements for banks ('CRD III'); stricter rules on hedge funds and private equity ('AIFMD'); stricter rules on short selling and credit default swaps; a comprehensive set of rule for derivatives ('EMIR'); a framework for reliable high-quality credit ratings; creation of the Single Euro Payments Area ('SEPA') as of 2014; markets in financial instruments (MiFID II; Trilogue agreement on 14 January 2014).

Other proposals included: reform of the audit sector; reform of the framework for market abuse; revision of current rules on markets in financial instruments and investment funds; shadow banking including Money Market funds and Securities law (proposal made in September 2013); revision of the governance of market benchmarks such as 'Libor' and 'Euribor' (proposal made in September 2013); innovative payment services (credit cards[9], etc.); creation of long-term European investment funds; review of the banking sector structure reform by the high-level expert group headed by Erkki Liikanen.

The Liikanen Report (2012) addressed two problem areas in the EU financial sector: 'Too big to fail' and the 'two-tier banking system'. Based on proposals in the Liikanen report, but not so far-reaching, are attempts by

[9] On 24 July 2013 the European Commission presented a proposal for regulation of the capping of interbank fees (for credit and debit cards).

the European Commission to ban proprietary trading ('prop trading' or PPT). The Commission's proposal is simply a lighter version of a 'two-tier banking system' ('Son of Glass-Steagall'), but it should be the last piece required to solve the puzzle of the 'Too big to fail' problem in the EU. The proposal would cover only the largest banks, some 30 large (globally system relevant – G-SIIs) banks in the EU plus some US and Japanese banks with subsidiaries in the EU («Neue Zürcher Zeitung», 7 January 2014: 19).

4. European Banking Union

The GFC of 2008-2009, and in particular the various rescue measures in the euro area since the start of the euro crisis – often caused by banking crises – have prompted calls for the creation of a banking union (European Commission 2012b; German Council of Economic Experts 2012; CESifo Forum 2012; Breuss 2012).

4.1 Rationale and vision

The need for a greater integration of the European banking sector within a 'banking union' can already be deduced from the previously identified «problems in the European banking sector». Above all, it is necessary to «break the link between sovereign debt and bank debt and the vicious circle which has led to over € 4.5 trillion (or 37% of EU GDP) of taxpayers' money being used to rescue banks in the EU» (European Commission 2012b: 3).

Cœuré (2012) discerns an ulterior justification for the EBU. Since the start of the euro crisis, there has been a close relationship between banks and sovereign debt and the opinions of the rating agencies (see also Gros 2013; Mayer 2013). The sovereign debt crisis has also led to a fragmentation of the credit markets in the Eurozone, which – in addition to the fragmentation of government bond markets (increase in interest spreads after the Greek crisis) – affected both banks and the non-bank private sector. Since the outbreak of the euro crisis in early 2010, there has been – especially in the peripheral countries of the Eurozone – a close link between sovereign debt and bank creditworthiness which is clearly visible in the high degree of correlation between sovereign CDS premia and bank CDS premia within the same jurisdiction. In the US, with a well-integrated fiscal and banking union absorbing shock mechanisms (fiscal federalism) at federal level, credible discipline at state level (effective 'no bail-out') and a central regulatory mechanism for the monitoring and resolution of banks (bank insolvency law), there is no correlation between CDS spreads for banks and governments. The same, incidentally, is also true of Germany!

On the basis of the first report of the President of the European Council, Van Rompuy (2012a), submitted on 26 June 2012 – in close liaison with the Presidents of the Commission and the ECB – on 29 June 2012 the Heads of

State or Government of the euro area (Euro Area 2012) and the European Council (2012a) requested the European Commission to prepare a proposal for a common banking supervision. On 12 September the European Commission (2012b) presented *A Roadmap towards a Banking Union*.

The Commission's proposals are based on the vision of establishing a banking union in three stages as envisaged in the report by Van Rompuy (2012a) and then modified and refined on 6 December 2012 (Van Rompuy 2012b). Van Rompuy's plan for a stable and prosperous EMU is based on four building blocks: (1) integrated financial framework; (2) integrated budgetary framework; (3) integrated economic policy framework to ensure growth, employment and competitiveness; (4) ensuring democratic legitimacy and accountability in decision-making in the EMU.

The 'Van Rompuy plan' to create a new EMU as of December 2012 (similar to the plan by Barroso 2012b) stipulated that the 'Integrated Financial Framework' (Banking Union) would be built in three stages. First, in 2014 a 'single supervisory mechanism' would be implemented, to be followed by a 'single resolution mechanism', after which a 'single deposit guarantee mechanism' would complete the European Banking Union. The Heads of State or Government agreed upon these proposals at the meetings of the European Council (2012a, 2012b) on 29 June and 14 December 2012. They commissioned the legislators of the EU (the Commission and the European Parliament) to prepare appropriate legal action.

4.2 Realization in three steps

After the euro crisis revealed a disastrous combination of sovereign and banking debt crises for taxpayers, the EU aimed at a thoroughgoing solution, i.e. stronger monitoring and harmonization of the European banking sector at EU level. Ultimately the internal market should be completed by financial services and an 'integrated financial framework' for the EMU would thereby be created.

Building on the strong regulatory framework common to the 28 members of the single market (single rulebook), the European Commission therefore took an inclusive approach and proposed a roadmap for the Banking Union with different steps, potentially open to all Member States but in any case for the 18 Member States within the euro area (6,000 banks).

The European Banking Union (EBU) should be created in three steps[10] (see Figure 1): surveillance with a Single Supervisory Mechanism (SSM);

[10] The European Commission (2012a: 2) also speaks of four pillars of a future EBU: (1) a single EU deposit guarantee scheme covering all EU banks; (2) a common resolution authority and a common resolution fund for the resolution of, at least, systemic and cross-border banks; (3) a single EU supervisor with ultimate decision-making powers, in relation to systemic and cross-border-banks; and (4) a uniform 'single rule book' for the prudential supervision of all banks.

resolution with a Single Resolution Mechanism (SRM); deposit guarantee with a Single Deposit Guarantee Mechanism (SDM).

The foundation of this EBU structure (mandatory participants are all euro area countries; EBU is also open to all EU Member States) is the 'Single Rulebook' with EU law applicable to all EU Member States (primarily the implementation of Basel III rules and the EU rules for bank resolution in the BRRD). The SRM and the SDM will have a long transitional phase (10 years) during which national mechanisms will be in place.

4.2.1 Single Supervisory Mechanism

On 4 November 2013, about one year after the Commission had proposed to set up a single banking supervision mechanism in the euro area, the SSM Regulation[11] entered into force (European Commission 2013f; see also ECOFIN 2013b). The ECB actively commenced its new role of supervisor[12] carrying out a comprehensive assessment of all banks which would be under its direct supervision and the balance sheets of those banks[13]. In parallel it planned to recruit highly-qualified supervisory staff and build up a new supervisory structure to integrate national supervisors before the start of its activities.

4.2.1.1 The ECB assessment

The assessment of 128 large euro area banks began in November 2013 and took a year to complete. It was carried out in collaboration with the national competent authorities (NCAs) of the Member States participating in the SSM, and was supported by independent third parties at all levels in the ECB and in the national competent authorities.

[11] The legislative package of the SSM consists of two regulations. The first governs the future competences of the ECB and the second those of cooperation with the European Banking Authority (EBA): (1) ECB as Supervisor: Council Regulation (EU) no. 1024/2013 of 15 October 2013, *Conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*, OJ, L 287/63, 29 October 2013 (SSM Regulation), i.e. the SSM is based on Article 127 (6) of the Treaty on the Functioning of the European Union (TFEU), which provides a legal basis for conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions and other institutions with the exception of insurance undertakings. (2) ECB cooperation with the EBA: Regulation (EU) no. 1022/2013 of the European Parliament and of the Council of 22 October 2013, *Amending Regulation (EU) no. 1093/2010 establishing a European Supervisory Authority (European Banking Authority – EBA) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) no. 1024/2013*, OJ, L 287/5, 29 October 2013. The legal basis is Article 114 TFEU.

[12] See the ECB website for the description of its new 'banking supervision' tasks as part of the SSM: <http://www.ecb.europa.eu/ssm/html/index.en.html>.

[13] See ECB website: <http://www.ecb.europa.eu/press/pr/date/2013/html/pr131023.en.html>; and ECB 2013.

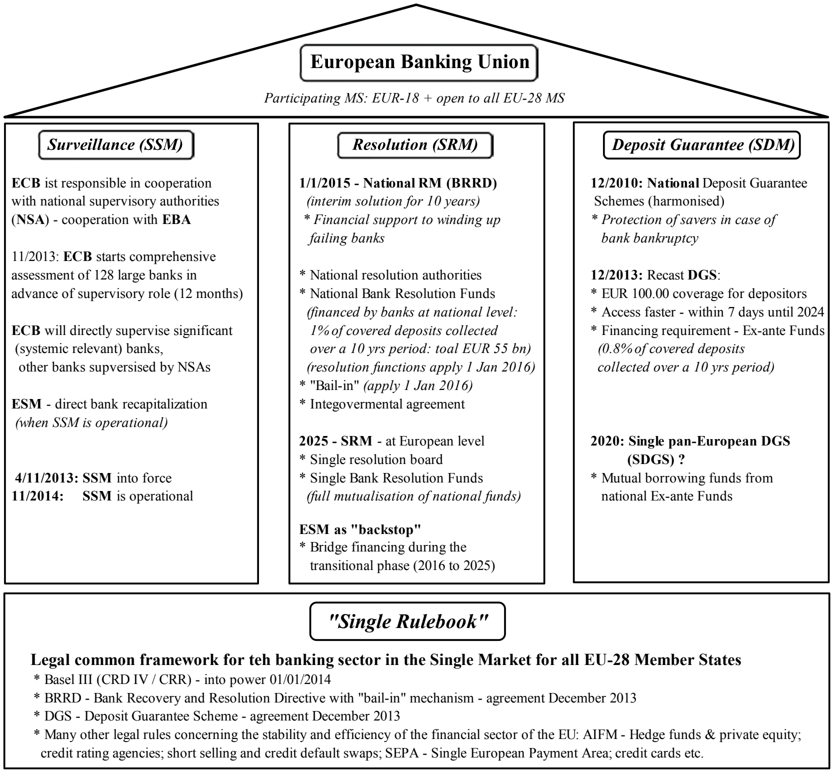

Figure 1 – The first blueprint of the European Banking Union.
DGS = Deposit Guarantee Scheme; EBA = European Banking Authority; ESM = European Stability Mechanism; SDGS = Single Deposit Guarantee Scheme; SDM = Single Deposit Guarantee Mechanism; SRM = Single Resolution Mechanism; SSM = Single Supervisory Mechanism.
Source: Own representation.

The exercise had three main goals: transparency – to enhance the quality of information available about the condition of banks; repair – to identify and implement necessary corrective actions, if and where needed; and confidence building – to assure all stakeholders that banks are fundamentally sound and trustworthy.

The assessment consisted of three elements: (i) a supervisory risk assessment to review, quantitatively and qualitatively, key risks including liquidity, leverage and funding; (ii) an asset quality review (AQR) to enhance the transparency of bank exposures by reviewing the quality of banks' assets, including the adequacy of asset and collateral valuation and related provisions; and (iii) a stress test to examine the resilience of banks' balance sheets to stress scenarios. These three elements are closely interlinked. The assessment was based on a capital benchmark of 8% Common Equity Tier 1, drawing on the definition of the Capital Requirements Directive IV/Capital Requirements Regulation, including transitional arrangements, for both the AQR and the baseline stress test scenario.

The comprehensive assessment concluded with an aggregate disclosure of the outcomes, at country and bank level, together with recommendations for supervisory measures. This comprehensive outcome was published in October 2014 prior to the ECB assuming its supervisory role and included the findings of the three pillars of the comprehensive assessment.

4.2.1.2 Main features of the SSM[14]

- It confers new supervisory powers on the ECB for the banks of the euro area: the authorization of all banks in Europe and the coherent and consistent application of the single rulebook in the euro area, direct supervision of significant banks, including all banks having assets of more than EUR 30 billion or constituting at least 20% of their home country's GDP (around 130 banks) and monitoring of the supervision exerted by national supervisors on less significant banks. The ECB may at any moment decide to directly supervise one or more of these credit institutions to ensure consistent application of high supervisory standards.
- The ECB shall ensure the coherent and consistent application of the Single Rulebook in the euro area.
- The SSM is open to all non-euro area Member States.
- For cross-border banks active both within and outside Member States participating in the SSM, existing home/host supervisor coordination procedures will continue to exist as they do today.
- The governance structure of the ECB will consist of a separate Supervisory Board supported by a steering committee, the ECB Governing Council with the right to object to Supervisory Decisions from the Board and a mediation panel. On 16 December 2013 the EU Council appointed Danièle Nouy as first Chair of the SSM at the European Central Bank.
- The ECB's monetary tasks will be strictly separated from its new supervisory tasks (Article 18 of the SSM Regulation), in order to eliminate potential conflicts of interest between the objectives of monetary policy and prudential supervision (see the criticism of the German Council of Economic Experts 2012: 186). To this end, a supervisory board responsible for the preparation of supervisory tasks will be set up within the ECB (Article 19; it is composed of four representatives of the ECB appointed by the Executive Board of the ECB and one representative of the national authority competent for the supervision of credit institutions in each

[14] See European Commission 2013f.

participating Member State). The board's draft decisions will be deemed adopted unless rejected by the ECB Governing Council.

4.2.2 Single Resolution Mechanism

The second building block for a fully-fledged banking union is the creation of the Single Resolution Mechanism (SRM). The reinforced regulatory and supervisory framework of the SSM and enhanced prudential requirements will bolster the safety of banks (European Commission 2013f). However, the risk of a bank experiencing a severe liquidity or solvency problem can never be totally excluded. In the EBU bank supervision and resolution need to be exercised by the same level of authority and be backed by adequate funding arrangements. Otherwise tensions between the supervisor (ECB) and national resolution authorities may emerge over how to deal with ailing banks, while market expectations about Member States' ability to deal with bank failure nationally could persist, reinforcing feedback loops between sovereigns and banks and fragmentation and competitive distortions across the single market. Swift and decisive actions at central level, backed by EU-level funding arrangements, are also needed to prevent nationally-conducted bank resolution from having disproportionate impacts on the real economy, and in order to curb uncertainty and prevent bank runs and spreading contagion to other parts of the euro area.

Therefore, on 10 July 2013, the European Commission presented a legislative proposal for the SRM (SRM Regulation, European Commission 2013d) at EU level. The SRM is intended to complement the ECB supervision as part of the SSM. The SRM Regulation basically applies the substantive rules of the Bank Recovery and Resolution Directive (BRRD) in a coherent and centralized way, ensuring consistent decisions for the resolution of banks through a Single Resolution Board and will comprise common resolution financing arrangements (including a Single Resolution Fund).

The SRM should ensure that if, notwithstanding stronger supervision, a bank subject to the Single Supervisory Mechanism encounters serious difficulties its resolution can be managed efficiently. In case of cross-border failures, it would be much more efficient than a 'network of national resolution authorities' and avoid risks of contagion. The SRM will take over when the ECB, as supervisor, flags a bank which needs to be resolved in the euro area or established in a Member State participating in the EBU. As the SRM is corollary to the SSM, Member States outside the Eurozone which join the SSM will also join the SRM.

4.2.2.1 Ten-year national transition before the SRM is operational

Legal interpretations of the TFEU regarding a SRM at European level differ between the European Commission and the Member States (in particular

Germany). In some countries (e.g. in Germany) there are also political hurdles to a 'Europeanization' of the resolution mechanism and the 'collectivization' of money of those already existing – e.g. the German Restructuring Fund. Germany fears that banks in countries with a relatively sound banking structure, such as Germany, would be liable for those in countries with a poor banking structure. Whereas the European Commission (the Internal Market Commissioner, Michel Barnier) considers the SRM backed by Article 114 of the TFEU, Germany (Finance Minister Wolfgang Schäuble; see also Höltschi 2013a) calls for Treaty change[15]. As a compromise, an interim solution was agreed, starting with a network of national resolution mechanisms which would then gradually merge after ten years into the SRM at EU/euro area level. On 18 December 2013 the Council (ECOFIN 2013c) set out its position on the establishment of a single resolution board and a single fund for the resolution of banks[16].

The ECOFIN called on the presidency to start negotiations with the European Parliament with the aim of agreeing the regulation on the SRM at first reading before the end of the Parliament's legislature in May 2014.

The compromise reached within the ECOFIN Council consists of a draft regulation on the SRM and a decision by euro area Member States committing them to negotiate an intergovernmental agreement on the functioning of the single resolution fund by 1 March 2014. This agreement, in line with terms of reference also approved, would include arrangements for the transfer of national contributions to the fund and their progressive mutualization over a ten-year transitional phase (10 years of national funds, then a European fund). It would endorse the bail-in rules established in the bank recovery and resolution directive (BRRD) as applicable to the use of the single fund.

Single Bank Resolution Fund (SRF): the SRF would be financed by bank levies raised at national level. According to the BRRD Directive each EU Member State must establish National Bank Resolution Funds[17]. On the ba-

[15] However, the project of a 'Europeanization' of the bank resolution is demanded from all institutions (European Commission, European Council, EMU reform plans of Van Rompuy and Barroso). Even the Franco-German paper on the reform of the monetary union, which German Chancellor Angela Merkel and French President François Hollande presented on 30 May 2013 (France-Germany 2013), calls for a «uniform resolution body that integrates the national resolution authorities» and can be created on the basis of the existing EU Treaties. According to EU Internal Market Commissioner Michel Barnier, given the interdependence of banks in the euro area the fragmentation of the authorities should be put to an end (Höltschi 2013a, 2013b).

[16] In addition to the final agreement reached by the legislators on the Deposit Guarantee Scheme Directive (DGSD) and the Bank Recovery and Resolution Directive (BRRD), the European Council (2013) also welcomed the general approach and the specific conclusions reached by the Council (ECOFIN) on the Single Resolution Mechanism (SRM) as a crucial step towards the completion of the Banking Union.

[17] In Germany there is already such a fund (amounting to EUR 1.3 billion at the end of 2012; «Der Standard», online: 27 June 2013).

sis of 2011 data on banks and an estimated amount of covered deposits held in banks in the euro area, the 1% target level for the Single Resolution Fund would correspond to around EUR 55 billion (based on more recent data the target value could be higher, EUR 80 billion for EU-27 and EUR 60 billion for the euro area). The target size of the Fund in absolute amounts (euros) will remain dynamic and will increase automatically if the banking industry grows. A transitional period of 10 years is foreseen before the Fund reaches its full target level. The SRF would initially consist of national compartments that would be gradually merged over ten years. During this ten-year period, mutualization between national compartments would progressively increase. So while during the first year the cost of resolving banks (after bail-in) would mainly come from the compartments of the Member States where the banks are located, the share would gradually decrease as the contribution from other countries' compartments increases.

The creation of an SRM will ensure that supervision and resolution are exercised at the same level for countries that share the supervision of banks within the SSM. This will prevent the emergence of tensions between supervision at EU level and national resolution regimes. The SRM will cover all countries participating in the SSM, namely the euro area Member States and those non-Eurozone countries that decide to join the SSM via close cooperation agreements.

Single Resolution Board: the draft regulation agreed by the Council provides for a Single Resolution Board[18] with broad powers in cases of bank resolution. Upon notification by the ECB that a bank is failing or likely to fail, or on its own initiative, the board would adopt a resolution scheme placing the bank into resolution. It would determine the application of resolution tools and the use of the single resolution fund. Decisions by the board would enter into force within 24 hours after their adoption, unless the Council, acting by simple majority on a proposal from the Commission, objects or calls for changes.

The board would consist of an executive director, four full-time appointed members and the representatives of the national resolution authorities of all the participating countries. It would exercise its tasks in either a plenary or executive format. Most draft resolution decisions would be prepared in the executive session, attended by the executive director and the appointed members, with the representatives of Member States affected by a particular resolution decision involved in an initial stage.

[18] Schoenemaker and Gros (2012) suggest that a new European Deposit Insurance and Resolution Authority (EDIRA) should commence simultaneously with the ECB's supervisory power via the SSM. The President of the European Parliament, Martin Schulz, threatened to shatter the ECOFIN compromise on the SRM in view of its pitfalls concerning the speed of resolution of banks and the 'multiplicity' of national institutions instead of one at European level (e.g. the European Commission; see «Die Welt», 19 December 2013).

Plenary Session: The plenary session would be responsible for decisions that involve liquidity support exceeding 20% of capital paid into the fund, or other forms of support, such as bank recapitalizations, exceeding 10% of funds, as well as all decisions requiring access to the fund once a total of EUR 5 billion has been used in a given calendar year. In these cases, decisions would be taken by a two-thirds majority of the board members representing at least 50% of contributions.

The plenary session, voting by simple majority, would also have the right to oppose decisions by the executive session that authorize the fund to borrow, and decisions on the mutualization of financing arrangements in the event of the resolution of a group with institutions in both SRM participating and non-participating EU countries.

To guarantee the budgetary sovereignty of the Member States, the draft regulation prohibits decisions that would require a Member State to provide extraordinary public support without its prior approval under national budgetary procedures.

The SRM would cover all banks in the participating Member States. The board would be responsible for the planning and resolution phases of cross-border banks and those directly supervised by the ECB, while national resolution authorities would be responsible for all other banks. However, the board would always be responsible if the resolution of a bank requires accessing the single resolution fund.

National resolution authorities would be responsible for executing bank resolution plans under the control of the single resolution board. Should a national authority not comply with its decision, the board could directly address executive orders to the bank in difficulty.

The SRM Regulation, based on article 114 of the Treaty on the Functioning of the European Union (TFEU), requires a qualified majority for adoption by the Council in agreement with the European Parliament. The intergovernmental agreement would enter into force once ratified by Member States participating in the SSM/SRM representing 80% of contributions to the single resolution fund.

State aid and bank resolution: in any case the state aid rules on burden-sharing will apply if resolution actions involve government support ('bail-out'). In order to implement the burden-sharing by shareholders and junior creditors, the SRM would apply from the application of this Regulation, rules allowing the write-down of shares and subordinated debt to the extent necessary to apply the state aid rules.

Only after a ten-year transition period would the fully-fledged SRM become operational at EU level according to the proposals of the European Commission (2013d, 2013e, 2013f).

'Bail-in': the central element of the bank resolution according to the BRRD and the SRM is the "Bail-in" procedure with its clear pecking order (burden-sharing) according to which the shareholders, creditors and possibly unsecured deposits are used first to cover losses and to finance the resolution in order to protect the taxpayer. This instrument – modelled after the bank bailout in Cyprus – will be central. 'Bail-in' would potentially apply to any liabilities of the institution not backed by assets or collateral, and not to deposits protected by a deposit guarantee scheme, short-term (e.g. interbank) lending, client assets, or liabilities such as salaries, pensions, or taxes.

- A 'cascade of burden-sharing' will apply: there will be a clear pecking order. In the first place, according to the ECOFIN compromise, the owners (shareholders) would have to pay, followed by the holders of hybrid capital and subordinated debt (junior bonds). In the third place, senior bonds and deposits of around EUR 100,000 from large companies, followed by deposits of around EUR 100,000 from individuals and SMEs. Liabilities to the European Investment Bank (EIB) would have preference over the claims of ordinary unsecured, non-preferred creditors and depositors from large corporations. Customer deposits up to EUR 100,000 remain untouched. A number of liabilities (e.g. deposits covered, secured debt, fixed salary and pension claims, interbank liabilities with a maturity of less than 7 days, etc.) are permanently excluded from liability.
- Liability: in order to have enough absorption capacity available in the event of a crisis, banks should hold a minimum of 8% of their total assets (minimum requirements for own funds and eligible liabilities – MREL), i.e. shareholders and creditors of the banks are liable first, to the amount of at least 8% of the total liabilities. Should still greater losses be incurred, an additional 5% will be covered by the national resolution funds or the ESM. If the financial needs exceed the threshold of 13%, bank investors (large investors above EUR 100,000) will be asked to pay again. In 2016, a review clause will allow the European Commission, based on recommendations of the European Banking Authority (EBA), to introduce a harmonized MREL rule for all banks. When the liability rule should apply is still open. This is planned for 2018.

4.2.2.2 Backstop before the EBU is in place

Eurogroup and ECOFIN ministers (Eurogroup 2013b) also adopted a statement on the design of a backstop to the single resolution fund. The statement specifies that during the initial build-up phase of the fund (over a 10-year transition period), bridge financing will be available from national sources, backed by bank levies, or from the European Stability Mechanism (ESM) according to existing procedures. Lending between national compartments would also be possible. During this transitional phase a common backstop will be developed, which will become fully operational at the latest after ten years. The backstop would facilitate borrowings by the fund. It would ultimately be reimbursed by the banking sector through levies, including ex-post.

This statement reiterates the political agreement already achieved by the Eurogroup and ECOFIN ministers (Eurogroup 2013a) on 20 June 2013 on guidelines for the direct recapitalization of distressed banks by the ESM. Current bank aid from the ESM (e.g. in the case of Spain) was performed via the Member States: they received loans from the ESM, which were used to recapitalize banks. However, this operation increased the national sovereign debt.

To break the vicious circle between bank and sovereign debt crises, on 29 June 2012 the Heads of State or Government of the Eurozone decided that the ESM can directly recapitalize euro-area banks under certain conditions. There are close relationships between the individual components of the legislation of the Banking Union, especially the directive on bank recovery and resolution (Bank Recovery and Resolution Directive – BRRD) of 6 June 2012 and the directive for a deposit insurance system (Deposit Guarantee Scheme Directive – DGSD) of 12 July 2010.

With the implementation of these EU laws, guidelines for the new task of the ESM will be developed. The ESM will take the direct recapitalization of banks as a new task under Article 19 of the ESM Treaty. The ESM may – at the request of an ESM Member and in accordance with the provisions of the ESM Treaty – conduct direct recapitalizations of an institution only if the following criteria are met:

1. The institution has a systemic relevance or poses a serious threat to the financial stability of the euro area as a whole or the requesting ESM member (risk of infection, according to Article 3 ESM Treaty).
2. 'Bail-in': there will be a clear pecking order (burden-sharing) for recapitalization operations: private capital resources will be explored as a first solution, including sufficient contributions from existing shareholders and creditors of the beneficiary institution(s).
3. Of the total lending capacity of the ESM of EUR 500 billion, EUR 60 billion will be reserved for direct bank recapitalization. In addition, a burden-sharing scheme will determine the contributions of the requesting ESM Member and the ESM respectively. This scheme will comprise two parts: (i) if the beneficiary institution/s has/have insufficient equity to reach the legal minimum Common Equity Tier 1 (CET1) ratio of 4.5% as established in the Basel III framework/CRD IV/CRR, under a sufficiently prudent scenario of a stress test, the requesting ESM member will be required to make a capital injection to reach this level before the ESM enters into the capital of the institution/s. (ii) if (one of) the institution/s already meets the above-mentioned capital ratio, the requesting ESM member will be required to make a capital contribution alongside the ESM, equivalent to 20% of the total amount of the public contribution in the first two years after the entry into force of the instrument and to 10% afterwards. If the contribution in this first part were lower than would have been required in the second part, the requesting ESM member would be asked to inject an additional amount alongside the ESM to cover the difference.

4. Legacy of past bank rescue operations: how far the ESM will be able to retroactively take over ongoing bank support will be decided uniformly from case to case. Possible candidates would be Greece or Ireland. Spain has no interest.

4.2.3 Single Deposit Guarantee Scheme

In the early discussion about a European Banking Union, when presenting the four-pillar concept of a EBU the European Commission (2012a) also reflected on the need for a Single Pan-European Deposit Guarantee Scheme (SDGS). However, the idea was rejected on the grounds that it was unlikely to be politically implementable. Similar arguments and objections to those of the SRM at EU level apply also in the case of a SDGS. A common (single) deposit insurance at EU/Eurozone level is viewed more sceptically and rejected more or less emphatically in the core countries of the Eurozone (especially Germany), whereas it is advocated in the peripheral countries, as in the case of rescue operations via the ESM. The transfer donors tend to be opposed, the transfer recipients in favour.

At an early stage, the European Commission (2010) speculated about the SDGS and argued that a single pan-European scheme would have two main advantages: first, the impact assessment estimates that € 40 million in administrative costs could be saved per year; second, it could better deal with bank failures. The impact of a single bank failure on a large scheme is less than on a scheme covering the banking sector of only one Member State.

However, there are complicated legal issues which would need to be examined. The idea of a pan-EU Deposit Guarantee Scheme remains a potential longer-term project. Subsequently the European Commission (2013f) declared that it is not envisaged to equip the banking union with a single supranational DGS at this stage. The priority is to reach an agreement on a common network of national deposit guarantee schemes. Once agreed, the proposal on DGS will ensure that every Member State has a deposit guarantee fund which is properly funded, *ex ante*. The text also paves the way to a voluntary mechanism of mutual borrowing between the DGSs of different EU countries. This is the only form of mutualization foreseen at this stage.

As described in section 3.3.2.2, on 17 December 2013 a political agreement was reached between the European Parliament and EU Member States on the new rules on Deposit Guarantee Schemes (European Commission 2013g). The DGS Directive will strengthen the existing system of national DGS to respond to the weaknesses revealed by the financial crisis. Depositors will continue to benefit from a guaranteed coverage of € 100,000 (EU law since December 2010) in case of bankruptcy, but access to the guaranteed amount will be easier and faster. Repayment deadlines will be gradually reduced from the current 20 working days to 7 in 2024.

4.3 Winners and losers in the EBU

4.3.1 Cost-benefit analysis of joining the EBU

To recap the rationale for creating a European Banking Union (EBU), and hence a truly integrated European-level banking system, two major targets emerge: (1) the EBU can foster financial stability in Europe, in particular in the euro area by breaking the 'diabolic loop' between national governments (sovereign debts) and banks (bank debt); (2) the EBU would take into account the cross-border externalities of large banks; normally, national governments concentrate only on the domestic effects of bank failures and ignore cross-border effects.

In a cost-benefit analysis Schoenemaker and Siegman (2013a, 2013b) calculate the net benefits of switching from a national bail-out to a European-level bail-out mechanism. The benefits of joining the EBU stem from the efficiency gained by moving from the home rule to a supranational rule (SRM at EU/euro area level). This is calculated by aggregating the efficiency gains of joining the EBU of the 25 largest European banks (located in 10 euro area countries; 2011 balance sheet data) to receive the country-specific effects. Total costs of joining the resolution mechanism of the EBU are based on the ECB capital key. Each euro area country would have to pay the same amount into a Single (European) Bank Resolution Fund (SEBRF)[19] which corresponds to the capital input into the ECB. By comparing benefits and costs Schoenemaker and Siegman (2013a, 2013b) obtain the net benefits for euro area and non-euro area countries. Out of the chosen list of 25 top European banks only 7 of these large banks are located in euro area countries – Belgium, France, Germany, Ireland, Italy, Netherlands and Spain – and only three in non-euro area countries (Denmark, Sweden and the United Kingdom). For the other countries with no big banks, joining the EBU results only in 'costs' according to the capital key of the ECB.

In the euro area the biggest 'net effects' would go to Spain (10.9%) and the Netherlands (3.1%). The biggest losers ('net payers') would be Germany (–6.7%), Italy (–3.9%) and France (–2.8%). These are followed by small euro area countries with only small banks, and therefore the 'net costs' are only the result of 'costs': Austria (–1.9%), then Portugal (–1.8%), Belgium (–1.6%), Finland (–1.3%), Ireland and Slovakia (each –0.7%), Slovenia (–0.3%), Estonia and Luxembourg (each –0.2%) and Malta and Cyprus (each –0.1%).

[19] Instead of a 'Single Resolution Board' and a 'Single Resolution Fund' as foreseen in the Commission's proposal for a future SRM, Schoenemaker and Gros (2012) propose an authority which would cover the 2nd (SRM) and 3rd (SDM) pillar of the planned EBU. They call this institution 'European Deposit Insurance and Resolution Authority' (EDIRA) which would manage a 'European Deposit Insurance and Resolution Fund' (EDIRF).

Non-euro area countries: whereas EBU membership is mandatory for euro area (EA) countries, non-euro area countries (also called 'outs') have the option to join the Banking Union. The United Kingdom and Sweden have declined to join the EBU. Nevertheless, Schoenemaker and Siegman (2013a: 22) also hypothetically calculate the costs and benefits of the non-euro area countries joining the EBU. The biggest 'net effects' would go to the United Kingdom (12.9%) and Sweden (8.6%); Denmark (0.3%). All other countries are losers – the biggest would be Poland (–4.9%), followed by Romania (–2.5%), the Czech Republic (–1.5%) and Hungary (–1.4%). The losses of the others are below 1%: Bulgaria (–0.9%), Lithuania (–0.4%) and Latvia (–0.3%). The cost-benefit analysis again underlines the asymmetry in the distribution of bank risks. The largest banks (with the exception of Spain) are located in the core of the EU/euro area.

4.3.2 Macroeconomic stabilization properties of the EBU

Applying the two-region euro area QUEST model for the banking sector (the euro area is divided into the 'periphery' –including Greece, Ireland, Italy, Portugal and Spain – and the 'core', comprising the remaining euro area countries) Breuss, Roeger and in't Veld (2015) simulate the stabilization effects of alternative bank resolution options in case of a financial shock in the periphery. In the baseline scenario (whereby the government of the euro area periphery does not intervene after a financial shock comparable to those of the GFC in 2008-09) the periphery would suffer a drop in GDP of 6% and the core of 0.4% (see Table 1).

Table 1 – First year GDP effects of alternative bank resolution options.

Scenarios	GDP periphery	GDP core	GDP euro area
1. No intervention: baseline	–5.99	–0.44	–1.85
National measures:			
2. National 'bail-out': periphery government rescue	–4.54	–0.33	–1.40
3. National 'bail-in'	–2.73	–0.21	–0.85
European Banking Union:			
4. EBU: SRM at EU/euro area level	–2.21	–1.00	–1.31
5a. ESM: backstop with loans	–3.22	–0.19	–0.82
5b. ESM: backstop with transfer	–2.06	–0.18	–0.66

Source: Breuss, Roeger and in't Veld (2015).

The EBU solution with the SRM at EU/euro area level is best from the perspective of the periphery (fall in GDP of only 2.2%) since it constitutes a transfer from the core banks to the periphery banks, but is worse for the core (fall in GDP of 1%). The backstop solution via ESM loans to the periphery banks is also costly for the periphery (GDP –3.2%). The least costly solution turns out to be an EBU based on a 'bail-in' of national depositors. This solution effectively overcomes national financial market inefficiency by making all households/savers share the risk/losses.

Within the logic of this model there is one solution which would minimize aggregate, core and periphery losses: this would be a backstop arrangement where the ESM provides transfers to periphery banks (GDP fall in the periphery of 2%; in the core of 0.2% and in the euro area of 0.7%). This solution would come close to overcoming both national and intra EA risk-sharing deficiencies by spreading losses to all households (equity owners/workers) in the EA. This analysis has shown that an EBU in the euro area can to a large extent overcome limited financial market integration.

4.3.3 Macroeconomic net benefits of the EBU

In an economic impact study, the European Commission (2012a: 16-17) analysed the costs and benefits of the proposed SRM. The costs of the framework are taken to derive essentially from the potential increase in the funding cost of banks due to the removal of implicit state support and from the costs of setting up resolution funds (first national and then a single bank resolution fund). Such increases in banks' costs could have negative effects for the GDP. On the other hand, the improved stability of the financial sector and reduced likelihood of systemic crises and risks for taxpayers' money to recapitalize failing banks, would have a positive effect on the GDP. New costs for banks should be minimal while the framework would work in a variety of crises of different magnitude (losses by EU banks during the recent crisis from 2008 to 2010 are taken as a key reference point).

Table 2 – Economic impact of Basel III, DGS/RF and Bail-in tool (debt write-down). Costs and benefits as % of annual GDP.

	Basel III	DGS/RF	Bail-in	Sum
Costs	0.16	0.04	0.14-0.42	0.34-0.62
Benefits	0.30	0.32	0.76	1.38
Net Benefits	0.14	0.28	0.34-0.62	0.76-1.04

Basel III, transformed into EU law by CRD IV; RF = Single (European) Bank Resolution Fund; Bail-in tool according to the rules of BRRD and SRM.
Source: European Commission 2012a: 17.

The efficiency and effectiveness of the proposed framework of an EBU is to be seen in the context of a joint calibration of Basel III rules, funding available under Deposit Guarantee Schemes (DGS) and the bail-in tool (BRRD and SRM). The new capital requirements under the Basel III accord (which reduces the probability of bank failures) are – according to the Commission's estimates (European Commission 2012a: 17) expected to generate net benefits equal to 0.14% of the EU GDP annually (see Table 2). The necessary funding of DGS or specific resolution funds (RF) are expected to bring positive net benefits equal to 0.2-0.3% of the EU GDP annually. The 'bail-in tool' could produce economic net benefits equal to 0.3-0.6% of the EU GDP annually. Overall, these measures are expected to generate a cumulative net benefit equal to 0.7-1.0% of the EU GDP annually.

The costs (in terms of GDP, investment, volume of loans, etc.) are estimated by the European Commission (2012a: 17) through a simple methodology also used by the Bank of England, and validated by the estimations of a dynamic general equilibrium macroeconomic model (QUEST III) that has been extended to incorporate financial intermediation by the banking sector. The benefits are estimated using the SYMBOL model, developed by the European Commission.

5. Conclusions

The euro crisis is due largely to unresolved banking problems in Europe. On the one hand, the European financial sector is highly fragmented because of national regulations. On the other hand, cross-border externalities disturb the functioning of the single market. Of the three main causes of the euro crisis (fragmented competitiveness, sovereign debt and banking crises) the latter two are intermingled in a vicious circle of sovereign debts and bank debt. A European Banking Union (EBU) would, in the first place, break the diabolic link between sovereign debts (national governments) and bank debt and the vicious circle which leads to rescuing banks using taxpayers' money (States as 'lender of last resort'). In the second place, the EBU would take into account the cross-border externalities of large banks. Normally, national governments concentrate only on the domestic effects of bank failures and ignore cross-border effects.

The state of play of the EBU is characterized by the mismatch of the ideal 'roadmap towards a Banking Union' proposed by the European Commission in September 2012 and the agreements reached so far. The three-pillar solution (SSM, SRM and SDM) based on the foundation of the 'Single Rulebook' led to the launch of the Banking Union in autumn 2014 with the SSM at the ECB. The SRM at EU/euro area level is postponed. In the 10-year transitional phase a network of national resolution mechanisms will manage bank failures. Gradually the national resolution funds will merge towards a mutualized Single Resolution Fund at EU/euro area level. The Single Deposit (Guarantee) Mechanism has been simply recast at national level (DGS). As always with EU projects they constitute work in progress. And the EBU project is one of the most important projects to complete the single market for financial services.

There are many problems connected with the EBU project. If only a subset of EU banks (only those of the euro area) is regularly supervised by the ECB, this promotes EU cleavage. This is especially true in the case of the increasing risks of banking in the new EU Member States in Eastern Europe. Moreover, it is questionable whether European banking supervision can better assess the risks of banks *ex ante* than national supervisory authorities, which furthermore were not always able to do this job properly. Although shadow banks are already targeted by the European Commission, they pose a great danger to the stability of the European financial sector. Many questions also remain open, especially how to handle 'shadow banks'.

First evaluations indicate that the net benefits of joining the EBU would be distributed unequally between the Member States of the EU/euro area. Germany would be the biggest loser, Spain and the Netherlands the biggest winners. Of the non-euro countries, the UK and Sweden have the most to gain, but Poland would lose. The country-specific gains of joining the EBU depend on the number and size of the banks located in a country. The resolution mechanism of the EBU would undoubtedly have a strong stabilising effect in the case of financial shocks. The outcome depends on the design. The best solution for all euro area countries would be a backstop solution via ESM with transfers to failing banks. Initial estimates by the European Commission indicate that, by preventing systemic banking crisis, a genuine EBU would result in macroeconomic net benefits for the EU in the range of 0.7% to 1% of annual GDP.

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PART III

Democratic Governance and Constitutional Reforms

Macroeconomic Adjustments and Reforms in the Euro Area

Christian Keuschnigg, Klaus Weyerstrass

1. Introduction

With the introduction of the euro the exchange rate risk was eliminated. Financial market participants evidently misperceived the sovereign risks since the interest rate differential relative to Germany, which the countries at the Southern periphery had previously been confronted with to compensate for the depreciation risk, decreased substantially and remained very low for many years. When the sovereign debt crisis began to take hold, the markets made reassessments and interest rates on the vulnerable sovereigns began to rise rapidly (Honkapohja 2013). On the other hand, the ongoing real catching-up process in the peripheral countries supported high wage and price increases after the introduction of the euro. Since these wage increases exceeded productivity growth, international price competitiveness was eroded, making the single currency too strong for these countries. In the wake of the financial and economic crises of 2008, growth stopped which made private and public debt levels unsustainable. As financial markets recognised the risk of government default of the countries with high public debt or other sources of public sector risk (in particular the potential need for bank bailouts), governments were confronted with increasing risk premiums. In some cases, this made the re-financing of public debt via capital markets impossible. These countries ultimately had to accept financial assistance by the international community, subject to strict and painful fiscal and structural reforms. Meanwhile reforms and economic adjustment in the crisis-struck countries have partly resulted in higher international price competitiveness and lower fiscal deficits. Although the fiscal and macroeconomic reforms negatively affect domestic demand in the short – and in some cases even in the medium – run, they create the basis for higher and more sustainable growth in the future. At the same time, the euro area has reacted to the financial and eco-

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nomic crisis by creating several new institutions, strengthening the mutual economic surveillance and cooperation of the Member States. To mention are the European Stability Mechanism (ESM), the 'Six Pack' that covers fiscal and macroeconomic surveillance under the new Macroeconomic Imbalance Procedure, and steps towards a banking union. On 2 August 2012, the ECB announced its OMT (Outright Monetary Transactions) programme. Under OMT, the Eurosystem may buy government bonds that mature in 1 to 3 years, provided the bond-issuing countries agree to domestic adjustment measures – the latter being the so-called term of 'conditionality'. The announcement of the OMT programme stabilised investor confidence and eliminated speculative risk-premiums.

2. Emergence of the crisis

The introduction of the common currency in 1999 implied the transfer of the responsibility for monetary policy from the national level to the European Central Bank (ECB). It also eliminated the member countries' independent nominal exchange rates as key relative prices that could adjust to avoid large trade imbalances and unsustainable international borrowing resulting from divergent wage and productivity developments. The smooth operation of a common currency area requires that independent exchange rates are replaced by other adjustment mechanisms. The theory of optimal currency areas (OCA) mentions four such mechanisms (see, e.g., Beetsma, Giuliodori 2010; Buiter, Rahbari 2011; De Grauwe 2009; Feldstein 2011; Keuschnigg 2012; Lane 2006, 2012; Sapir 2011; Shambaugh 2012; Sinn, Wollmershäuser 2011): (i) wage flexibility to align unit labour costs with international competitiveness; (ii) labour mobility; (iii) central fiscal institutions to provide insurance against asymmetric shocks; and (iv) strict fiscal rules to prevent negative spillovers of national fiscal policies on other member countries.

Until recently, none of these four conditions for an optimal currency area had been fulfilled in the euro area. Only few member countries have reformed their labour markets so as to enable sufficient wage flexibility that can compensate for the exchange rate as an adjustment mechanism. Due to cultural and language barriers, labour mobility across countries tends to be low in Europe and is certainly not sufficient to significantly reduce the large differences in unemployment and other labour market conditions. There is no central layer of government with a budget that could provide fiscal insurance against asymmetric shocks and thereby dampen economic fluctuations. The EU budget is far too small to achieve any significant automatic stabilisation in the case of a negative economic shock. Finally, the fiscal rules of the Maastricht Treaty and of the Stability and Growth Pact have not been credible; in fact they have been ineffective in preventing the sovereign debt crisis in the euro area. When the large Member States Germany and France violated these principles in the first place, this sent out a clear signal to the smaller Member States that they would not have to fear any consequences should they breach the deficit or debt threshold.

If a country loses competitiveness, an external devaluation would make exports cheaper on world markets and renders imports more expensive. In the euro area, external devaluation is not possible for the individual member countries and must be replaced with a painful process of internal devaluation that reduces unit labour costs to regain competitiveness in the tradable sector. A country may also improve its competitiveness by means of 'fiscal depreciation' which shifts the tax burden away from labour towards indirect taxes in order to reduce labour costs. Internal devaluation leads to substantial income losses and transitional unemployment but is unavoidable to eliminate external deficits since it is required to reallocate production factors from the non-tradable to the tradable sector to generate more export earnings and substitute for imports. For structural change to be successful, labour market reforms must allow the termination of unprofitable employment as a precondition for new jobs in more competitive and profitable sectors. During the adjustment process the country experiences a severe recession with high unemployment which is reversed only slowly with the expansion of the tradable sector.

It might be argued that in some countries, particularly in Greece, fiscal austerity measures and internal devaluations have unbearable consequences for economic growth and employment, predominantly for the youth. Therefore, Allen and Ngai (2012) argued that countries with excessive public debt and external deficits should better leave the euro area as internal devaluation would require intolerable fiscal austerity measures and substantial wage decreases. If an uncompetitive economy were to leave the euro area, the exchange rate of the national currency would probably overshoot. A large one-off depreciation would immediately restore competitiveness and speed up new export led growth. Internal devaluation by wage moderation or even nominal wage cuts is much slower in restoring competitiveness, prolonging the adjustment recession and delaying growth. Sovereign default and a temporary exit from the euro could provide shock absorbers for countries and have the potential to be more efficient than current austerity policies and nominal wage and price cuts. The resulting competitive devaluation would restore relative prices and allow the exiting country to become more competitive on the global markets. Positive examples of countries that were able to take advantage of external devaluations were Argentina, Finland and Korea (Allen, Ngai 2012). On the other hand, a sharp external devaluation upon a euro area exit would cause substantial costs in terms of higher import prices with negative social costs, since some imported goods can only be substituted to a small extent. Furthermore, the debt denominated in euro would increase significantly, making public and private insolvencies very likely.

The current account crisis in Southern periphery countries is partly a result of capital market failure. Prior to the introduction of the euro, peripheral countries with competitiveness problems faced higher interest rates to compensate for the exchange rate risk. These risk premiums disappeared with the introduction of the euro. It seemed inconceivable that member countries of the euro area could become insolvent. Market obviously expected that – in contrast to official statements – the community would always bail out member countries since insolvency would possibly endanger the existence of the currency union and would be more costly ex post than a bail-out. Given these expectations, interest rate differentials relative to German sovereign bonds disappeared entirely. Easy access to credit at record low interest rates in a generally expansionary environment fuelled a large investment and real estate boom. Many of these investments would not have been profitable had market interest rates included an adequate risk premium. Rapid demand growth prior to 2008, financed with large capital inflows, encouraged wage and price increases much higher than in the core countries that were not backed by real productivity growth, hence continuously eroding international competitiveness. These developments led to large private and public sector debt which contributed to the accumulation of current account deficits and foreign indebtedness. Access to credit was then abruptly stopped with the outbreak of the financial crises in 2008.

With only few exceptions, member countries of the euro area have accumulated government debt far in excess of the Maastricht benchmark of 60% of GDP. With differences across countries, excess public debt in Europe is partly due to insufficient fiscal discipline but also due to the costs of fiscal stabilisation and bank re-capitalisation after the outbreak of the economic and financial crisis in 2008. High fiscal debt also involves large scale redistribution at the expense of future generations. The crisis demonstrates that the currency union makes government debt more prone to speculative attacks and, thus, more risky. The ECB is not allowed to directly finance government debt which makes investors more worried about government default and raises the likelihood of panic driven capital flight. Since the start of the financial crisis, some countries were confronted with high risk premiums. Given their competitiveness problem and weak growth prospects, investors started to doubt their ability to repay. Ensuing capital flight depressed the value of bonds, and interest rates jumped up.

Since the emergence of the crisis, substantial efforts have been made so as to reform the economic governance on the European level and to correct fiscal and macroeconomic imbalances on the level of the Member States. These reforms will be addressed in the following sections (see also Keuschnigg, Weyerstrass 2015).

3. Financial assistance programmes

When government bonds yields increased substantially during the financial crisis, some euro area Member States were no longer able to finance their public deficits on the capital market. Financial assistance to these countries was first provided bilaterally, i.e. by the individual Member States. The first euro area country to get financial assistance during the severe financial crisis was Greece in May 2010 when a rescue package of 110 billion euro was agreed upon. These loans were provided by the euro area Member States and the International Monetary Fund (IMF). The loans were granted under strict conditionality regarding macroeconomic and fiscal reforms. The implementation of these reforms is continuously monitored by the so-called 'Troika' with experts from the European Commission, the ECB, and the IMF. These bilateral loans proved to be not sufficient to bring government bond yields down for Greece, and in addition also other euro area countries came under pressure by financial markets. Hence, the European Commission and the ECB decided to establish a temporary rescue package of 750 billion euro for the euro area, consisting mainly of guarantees. This package consists of the European Financial Stabilisation Mechanism (EFSM) (60 billion euro), the European Financial Stability Facility (EFSF) (440 billion euro), and IMF loans (250 billion euro). As this temporary rescue package was still not sufficient to restore the confidence of financial market participants into the sustainability of the euro area, policy makers decided that a permanent resolution mechanism able to provide financial stability support would be needed. Hence, the European Stability Mechanism (ESM) was established in 2012. ESM loans are provided step by step, subject to strict monitoring and surveillance, in exchange for fiscal and structural reforms that are designed to restore a country's debt servicing capacity. Unlike the EFSF, the ESM is endowed with a total subscribed capital of 700 billion euro provided by euro area Member States. Of this total amount, 80 billion euro is provided in the form of paid-in capital, while the remaining 620 billion euro takes the form of callable capital[1].

4. Reform of EU governance

As a reaction to the financial and economic crises, the EU initiated several reforms of the economic policy framework. By strengthening fiscal policy coordination and multilateral surveillance of the Member States, these reforms ultimately aim at preventing the build-up of large macroeconomic imbalances, and to keep public debt under control so as to prevent future bail-outs of Member States by the international community. Initially, such financial assistance and bail-outs were excluded by the Maastricht Treaty and the Stability and Growth Pact (SGP), but these rules turned out as not credible. Future fiscal policy rules will have to be more credible. Institutional reforms include the 'European Semester', the so-called 'Six Pack', and the Treaty on Stability, Coordination and Governance (TSCG), of which the fis-

1 See <http://ec.europa.eu/economy_finance/assistance_eu_ms/intergovernmental_support/index_en.htm>.

cal part is known as 'Fiscal Compact'. The Six Pack does not only cover fiscal surveillance, but also macroeconomic surveillance under the new Macroeconomic Imbalance Procedure (MIP). The Six Pack comprises five regulations and one directive. In the fiscal field, it strengthens the SGP[2]. The Six Pack and the Fiscal Compact are running in parallel.

The Fiscal Compact requires countries to ensure convergence of the fiscal balance towards the country-specific Medium Term Objective (MTO), with a lower limit of a structural deficit (cyclical effects and one-off measures are not taken into account) of 0.5% of GDP (1.0% of GDP for Member States with a debt ratio significantly below 60% of GDP). Furthermore, Member States with government debt exceeding 60 percent in relation to GDP shall reduce it at an average rate of at least 1/20 per year of the exceeded percentage points. In addition, an expenditure rule has been introduced according to which the annual growth of public expenditures (other than those related to the automatic stabilisers) shall not exceed nominal potential GDP growth. These budget rules have to be implemented in national law through provisions of «binding force and permanent character, preferably constitutional». In addition, the TSCG reinforces surveillance and coordination of economic policies. The 'Two Pack', adopted by the European Parliament in March 2013, is the latest piece of the EU's economic governance reform. The two regulations strengthen the legal basis of the economic policy coordination process, and they lay down clearer procedures for dealing with countries that are in severe difficulties or are receiving a EU bailout.

Recognising the fact that the budgetary problems which some Member States are confronted with are to a large extent rooted in the erosion of international competitiveness and the resulting build-up of macroeconomic imbalances, the EU has also introduced a procedure which aims at preventing and, if necessary, timely correcting macroeconomic imbalances in the Member States. This MIP was set up in December 2011 as part of the Six Pack legislation. An alert system was established based on a scoreboard consisting of a set of currently eleven indicators covering the major sources of macroeconomic imbalances: current account balance, net international investment position, export market shares, nominal unit labour cost, real effective exchange rate, private sector debt, private sector credit flow, changes in house prices, general government sector debt, unemployment rate, changes in total financial sector liabilities. For each indicator, alert thresholds have been defined to detect potential imbalances. The MIP has also a corrective arm, the Excessive Imbalance Procedure (EIP)[3].

2 These information have been taken from the homepage of the European Commission: <http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm>.

3 See <http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm>.

It is quite hard to assess how appropriate the design of the new institutions is with respect to handling the current crisis and in particular regarding their potential to make the euro area more resilient to future crises (Honkapohja 2013). However, while at the beginning of the crisis European policy makers were reacting rather than acting, in the course of time policy-making has become more pro-active so that the euro area should now be better suited to withstand future negative shocks.

5. Banking union

With the introduction of the euro and the deepening of the common capital market, cross-border banking activities increased substantially, but since 2008 a new disintegration can be observed. This development can be exemplified with respect to the share of foreign assets in Austrian Bank assets. As an example, the share of assets of Austrian banks invested abroad – mainly in other European countries – rose from 28% in 2000 to 39% in 2007. However, in the second Quarter of 2013 only 32% of the assets of Austrian banks were invested abroad (thereof 32% in the euro area, 72% in the EU and 56% in Eastern Europe: BIS 2013, OeNB 2013). Sovereign bonds of a country are held by banks and investors in all countries of the euro area. In 2013, foreign investors held around 70% of Austrian, 57% of German and 35% of Italian sovereign debt (IMF 2013a).

For overcoming the euro crisis and establishing a growth-promoting capital market, it is crucial to break the vicious circle between banks and sovereigns[4]. This hinges on three conditions: (i) States reduce their debt; (ii) on the capital markets investment decisions are grounded on economically realistic risk assessments rather than on fear driven speculation; and (iii) profitable banks build up more equity and are more resilient, while unprofitable banks can default in a controlled manner. The banking union aims at (ii) and (iii) in order to make the financial system safer[5].

Capital will promote growth only if it flows to those investment projects which yield the highest risk-adjusted profit. Interest rate differentials should reflect an economically justifiable risk and should not be driven by speculation and self-fulfilling prophecies. Speculative capital flight from the crisis countries and a withdrawal of unsettled investors into the safe havens of the north are harmful. Capital flight threatens the existence of banks since it disturbs the re-financing of loans with deposits; in this respect, capital flight

[4] An imminent sovereign default devaluates government bonds and endangers banks which are holding these assets. The other way round, a necessary bank rescue puts sovereigns into difficulties, since capital injections into the banking system increase public debt.

[5] An introduction to this discussion with many contributions can be found in e.g. Allen *et al.* (2013), Beck (2012), CESifo (2012) and IMF (2013b).

could aggravate an otherwise manageable crisis. A retreat into the safe havens leads there to artificially low interest rates and over-investment which are no longer profitable at normal interest rates, and could thereby sow the seeds of a new crisis.

Under Basel III, banks must build up more capital and higher liquidity buffers. Profitable banks can get equity from the capital market or through retained earnings. None of these options is available for unprofitable banks. Without a fundamental restructuring, a sustainable recovery of the European banking sector will be very difficult to achieve and take excessively long. The imminent possibility of a controlled bankruptcy of banks is a powerful incentive to pursue less risky strategies, and it is a prerequisite for stricter market discipline.

On 15 October 2013, the Ecofin Council adopted the Regulation on the Single Supervisory Mechanism (SSM) with the transfer of supervisory tasks to the ECB. The SSM has the following cornerstones:

- All euro area countries participate in the SSM. EU countries with their own currency can participate voluntarily.
- The Board of Directors consists of the Chairman, a Deputy Chairman from the Governing Board of the ECB, four ECB representatives, and one representative of each national supervisory authority.
- The ECB supervises the major banks directly, while the other banks remain under national supervision.
- The ECB will supervise directly about 130 major banks, which hold nearly 85% of bank assets in the euro area and in each country at least the three largest banks.
- Before the start of the SRM the ECB has to conduct stress tests so as to assess the asset quality of the major banks.

After the Council agreed on general principles of the Single Resolution Mechanism (SRM) on 18 December 2013, the following cornerstones of the banking union became known:

- The SRM includes all banks under the Single Supervisory Mechanism SSM.
- A Single Resolution Fund (SRF) is set up, which is fed from national bank contributions and with a target volume of 1% of all guaranteed deposits or about 59 billion euro[6]. The contributions should be based on the risk profile of the banks. The contributions will initially go into 'national chambers' of the fund and will gradually be mutualised over 10 years.

[6] In November 2013, guaranteed deposits in the euro area amounted to about 5,910 bill. euro, of which Austria accounts for about 180 bill. euro. In the long run, the resolution fund shall accumulate 59 bill. euro, of which Austria accounts for 1.8 bill; calculated on the basis of IMF Technical Background Notes (2013b: 43), European Commission (2010), and updated with ECB MFI statistics.

- The SRF will be used to cover costs of bank settlement and recapitalisation, where a strict liability order is to be observed: losses have first to be borne by owners, creditors and unsecured depositors before the insolvency fund or even the taxpayers will be charged.
- If in the build-up period the financial resources of the SRF are not sufficient, then as a backstop bridge financing must come from national sources, which is paid back by additional bank charges afterwards. In an emergency, a country can apply for an ESM loan. The 'national chambers' can also mutually extend loans. After 10 years, a common backstop will be established which should give the SRF the opportunity to borrow on the market.
- The SRM is governed by a Board consisting of the Executive Director, four elected full-time members, and representatives of all national resolution authorities. The ECB and the European Commission have observer status.
- The Board prepares resolution plans for the large banks supervised by the ECB according to the EU Directive on Ban Resolution. The national authorities prepare resolution plans for the smaller banks. However, the Board always decides when financial resources from the resolution fund are requested.
- The ECB as the supervisory authority determines the impending insolvency of a bank, and reports to the Board, the European Commission and the national authorities. The Board will decide whether a bank can be restructured, or otherwise initiates the resolution process. If the loss participation of the shareholders, creditors and large depositors is insufficient, a decision on financial assistance from the SRF is taken.
- Decisions by the Board shall become effective within 24 hours. On a proposal from the European Commission, the Ecofin Council may exert a veto or request changes.
- In the executive Board meetings that do the 'daily business', the Director and the four full-time members as well as observers from the ECB and the European Commission participate. Representatives of member countries where a bank is resolved can be consulted.
- The Board meets in full plenary sessions when the requested financial assistance exceeds certain thresholds: liquidity support over 20% of the paid-in capital, other assistance, e.g. for a bank restructuring over 10% of the capital, and all financial assistances if they exceed 5 billion euro per year. In these cases, decisions have to be taken with a 2/3 majority and must represent at least 50% of all contributions. With simple majority, the plenary session can block decisions of the executive sessions on borrowing by the Fund or on the communitisation of financial obligations in a liquidation process.

The exact rules of the SRM still have to be clarified in the legislative process, particularly regarding the complex voting procedures, the composition of the Board meetings in different cases and the backstop in case of an overburdening of the fund. However, the finalisation of the rules may not delay the decision-taking process. In the event of a crisis, the SRM must be able to act quickly, within a day. The costs for the security of the taxpayers are higher bank fees, which the banks have to earn first. In addition to higher bank service fees, either the lending rates will rise, or interest rates on deposits and other borrowings of the banks will decline, or the return on equity will decrease. Higher lending rates inhibit real growth. If banks reduce interest rates for savings deposits and other debt, then they get in trouble to refinance themselves, which would force them to reduce their credit supply. A lower return on equity would be justified if the banks became safer, and if risk-bearing equity investors would be content with a lower risk premium. However, in Europe the banks' profitability and return on equity are already very low, and the banks must also increase their higher equity ratios. In case the build-up of equity is difficult due to low yields, then a higher equity ratio can only be achieved with a reduction in loans, which in turn inhibits growth. In any case, the costs of financial stability must be priced in and can be reflected in higher lending rates and a lower loan volume.

It may be doubted that a resolution fund in the amount of 1% of guaranteed deposits is sufficiently large. If the capacity of the SRF turns out to be not sufficient, contributions must be increased. That depends on whether the higher security of banks sufficiently reduces the number of bankruptcies or resolutions, and how often the participation of the private sector in losses is sufficient. In the long run, the capacity may be sufficient. Much larger problems might arise in the process of establishing the fund, since during this phase the banking sector has to be restructured and the legacies of past failures have to be adjusted. During 2014, the ECB had to pursue a stress test and check the quality of the bank assets. This might reveal equity gaps and a number of de facto insolvency. Since in the initial phase the common fund is not yet available and the national funds still have to be endowed with capital, it will again be the governments who have to step in and go into debt, and eventually they may be forced to ask for ESM assistance again.

If the contributions are not actuarially fair, insurance will lead to cross-subsidisation and to excessively risky activities of the subsidised banks. Therefore, banks with riskier activities and less equity must pay higher insurance premiums. The banking union rules correctly claim that the contributions are based on the risk profile of the banks. Contributions should vary not only between banks within a country but also between countries. In countries with higher loan and deposit risks, banks should pay higher premiums. However, this is not adequate if a country is in crisis. In this case, the insurance principle without any redistribution can only work if the credit risks differ little between countries. This is possible only after the bank sector has been restructured with banks being either recapitalised or closed down, and after winding down excessive debt of borrowers. This justifies the gradual pooling of the insolvency fund. Costs of bank liquidations which are incurred already in the first year after the loss participation of private investors will be financed by the respective country. Afterwards national participation decreases, while the costs are increasingly financed by the common insolvency fund. If a solidarity and redistribution in the euro area is desired, then this should not be achieved by non-transparent cross-subsidisations of the banking sector, with distortions of competition and of the risk-taking behaviour of banks, but from taxpayers to taxpayers.

The deposit insurance remains national, but should be harmonised and guarantee 100,000 euro per customer and bank in all Member States. The payments are to be made faster. It is intended to set up deposit protection funds in each Member State, to the extent they are not already in place, and to build up reserves from contributions of the banks. As things stand, a mutual borrowing of the national deposit insurance funds should be possible on a voluntary basis. However, this is not systematic re-insurance of the national funds at the European level. A re-insurance would allow additional welfare-enhancing risk diversion between Member States and reduce the risk of capital flight by uncertain depositors. A re-insurance needs rules for borrowing of national funds at a central unit (own central deposit insurance fund, or as part of the central resolution fund SRF or of the ESM), together with an automatic increase of national contributions so that the debt is again repaid ex post. Otherwise, the national funds must ultimately be guaranteed by the Member States themselves, which in the worst case would have again to apply for emergency bridge financing from the ESM.

Special taxes for the financial sector are often justified by the claim that the banking sector is in large part responsible for the financial crisis and should thus pay for the costs. One problem with this is that just the most prudent banks would in the end have to pay for the insolvencies of their most aggressive competitors with particularly risky business models. Special levies on the financial sector should not be charged ex post to finance losses that have already occurred. They make sense only if they serve to prevent future crises. They should ex ante limit excessive risk-taking and correct misdirected incentives. The rationale for corrective taxes disappears if the external costs are already internalised with regulatory measures and risk-based insurance premiums. Since implicit government guarantees for banks will no longer exist, prices for such guarantees in the form of special bank taxes are not justified. They should be eliminated step by step with the building-up of the insolvency fund. Banks should pay no more and no less taxes than other companies.

The banking union should break the vicious circle between banks and sovereigns. This is partly inhibited by the rules that for the calculation of required equity under Basel III rules, government bonds get a risk weight of 0%, while corporate loans are weighted with 100%. Contrary to the experience of the euro crisis, government bonds are classified as absolutely safe, Greek as well as German. The preferred treatment of sovereign debt could be responsible for the credit crunch in the crisis countries. Especially in the crisis countries, banks have major problems with the compliance to the equity standards. They therefore invest in domestic government bonds as these yield high returns because of the high risk premium, but are considered to be absolutely safe and therefore do not require extra equity capital. It would therefore be worthwhile to take account of the actual risk of public debt when calculating required equity.

6. Macroeconomic and fiscal adjustments in the Member States

In this section, the macroeconomic adjustment progress which the crisis-struck countries have made so far is evaluated[7]. The global financial and economic crisis hit the euro area Member States via different channels and to different extents. While some countries, particularly Austria and Germany, experienced only a temporary drop in economic activity, followed by a quick recovery, countries with structural problems were thrown into a deep crisis. In Ireland a real estate bubble burst; at the same time the banking sector which had established itself as an international financial centre thanks to attractive taxation regulations, came into severe difficulties. Greece slipped into a severe crisis once investors realised the risks associated with the high public debt. The government had to concede that the true level of public debt was higher than officially published so far. In turn, risk premiums rose substantially, making it impossible for the Greek government to finance its public debt via capital markets. Furthermore, the erosion of international competitiveness of the Greek economy became increasingly visible, and the growth prospects deteriorated, giving rise to increasing concerns regarding the sustainability of public finances. The coincidence of high public debt and declining international competitiveness was also the main cause of the economic crises in Portugal and Italy, while Spain was confronted with different problems. There, public debt belonged to the lowest levels in the euro area prior to the outbreak of the global financial crisis. The recession of the Spanish economy was caused by the bursting of a real estate bubble which led to liquidity and solvency problems in the banking sector as an increasing part of loans became non-performing. In conjunction with the declining international competitiveness of Spanish companies and fast increasing unemployment, this resulted in rapidly rising public debt. In Cyprus the problems were caused by trouble in the banking sector which was also too large in relation to GDP. In addition, the Cyprus banking sector had been hit particularly hard by the haircut on Greek public debt.

7 This section draws on Joint Economic Forecast Project Group (2013: ch. 6).

In expectation of euro area membership, these countries experienced a substantial decline in long-term interest rates. This 'euro dividend' seemingly relaxed public and private sector budget constraints. Substantially lower interest costs and easy access to debt financing undermined incentives for cautious public spending and led to overly expansionary private spending, in particular in the construction and real estate sectors. As a consequence, domestic absorption rose significantly faster than domestic production. Rising employment reduced incentives for wage moderation and labour market reforms. The price level increased faster than the euro area average and continuously eroded international price competitiveness. High domestic absorption in conjunction with declining competitiveness resulted in the accumulation of high current account deficits and external debt. These divergence processes were fuelled by the fact that the common monetary policy of the ECB, which by design has to be adapted to the euro area average, was too expansionary for the peripheral countries.

During the boom, in most of the peripheral countries economic structures have emerged which the crisis has unveiled as not being sustainable. In some countries (in particular Spain), the construction sector, in other countries (Ireland, Cyprus) the banking sector became too large in relation to the overall economy. Now these sectors shrink very fast, while the re-allocation of production factors needs time. As a precondition for new growth, the countries must re-gain international competitiveness. Not only wages and prices must be aligned with productivity, but also the production structure needs to adjust to international demand. High-quality goods and services at internationally competitive prices are needed to expand the export sectors and import substituting industries which adds to new domestic investment, employment, and consumption. Sustainable economic growth is also a precondition for the ability to repay public debt in the medium to long run.

Since the outbreak of the financial and economic crises, the peripheral countries have made substantial progress in bringing prices and wages in line with productivity. They managed a real devaluation and a reduction of current account deficits. In addition, significant cuts in public spending and tax hikes, which have been agreed with international lenders in exchange for financial assistance, have reduced public deficits. In the following, we document the adjustment progress in the crisis-struck countries[8]. For the assessment of the adjustment progress, the following indicators are taken into account:

- Public finances. One of the main reasons for the crisis was the fact that the sustainability of public finances was increasingly questioned by international investors. Restoring sustainable public finances requires a balanced budget to stabilise the debt ratio. It is unrealistic to expect an

[8] Cyprus is not considered due to the short time period elapsed since the outbreak of the crisis.

immediate decline in the public debt ratio in the crisis-struck countries. In most cases the debt ratio is still increasing due to the 'adjustment recession' in the real economy as well as the negative impact of fiscal adjustments on private and public demand. Both factors contribute to low or even negative economic growth, resulting in high unemployment. Furthermore, the debt level is increased by financial assistance to the banking sector. We assess fiscal adjustment with respect to the overall budget balance and the primary budget balance, both in relation to nominal GDP.

- International competitiveness and current account. A key source of the crisis was the loss of international competitiveness of the peripheral euro area countries. The main measure of international price competitiveness is the real effective exchange rate (REER), which is here calculated on the basis of GDP deflators. Given low international competitiveness, high domestic absorption led to accumulating current account deficits and high external debt of the crisis-struck countries. Again, adjustment progress is sensibly not measured with respect to debt levels, but with a view to current account balances.
- Bank recapitalisation and capital flows. After the introduction of the euro, the elimination of exchange rate risk eliminated interest rate differentials in the euro area, leading to large capital flows to periphery countries. At the outbreak of the crisis, the large imbalances triggered a reassessment of sovereign and private sector solvencies, led to sharply increasing risk premiums and interest rates and triggered capital flight from the periphery to the safe core of the euro area. Weak bank capitalisation made banks vulnerable to an economic downturn and sovereign default. We document adjustment progress in terms of interest rate differentials, capital flows (deposits of foreigners in banks in the crisis countries, as well as Target2 balances), and bank capital ratios.

The following figures visualise the development of these indicators over the period 1999 to 2012. For most indicators, the forecasts of the European Commission for 2013 and 2014 are also shown (European Commission 2013). This makes both the emergence of the imbalance after the introduction of the euro in 1999 and the achieved adjustments since the outbreak of the crisis in 2008 visible.

Due to the working of automatic stabilisers, fiscal stimulation packages and financial support to the banking sector, public finances markedly deteriorated in nearly all EU countries during the 'Great Recession'. Since 2008, all countries considered here were able to reduce their budget deficits considerably, at least until 2011 (Figure 1). Ireland reduced its budget deficit from 14% in relation to GDP in 2009 and even 31 percent in 2011 to 7.6% in 2012. In Greece, Portugal, and Spain, in 2012 the budget deficit rose again somewhat due to the recession. With a deficit ratio of 3.0%, Italy exactly fulfilled the Maastricht deficit criterion in 2012. Furthermore, among the countries considered here Italy is the only one which has achieved primary budget surpluses in each year since 1999, except for 2009 (Figure 2). On the other hand, improving budget balances have nowhere been sufficient to reduce public debt levels (Figure 3). In Greece, the decline is exclusively attributable to the 'haircut' that became effective in March 2012.

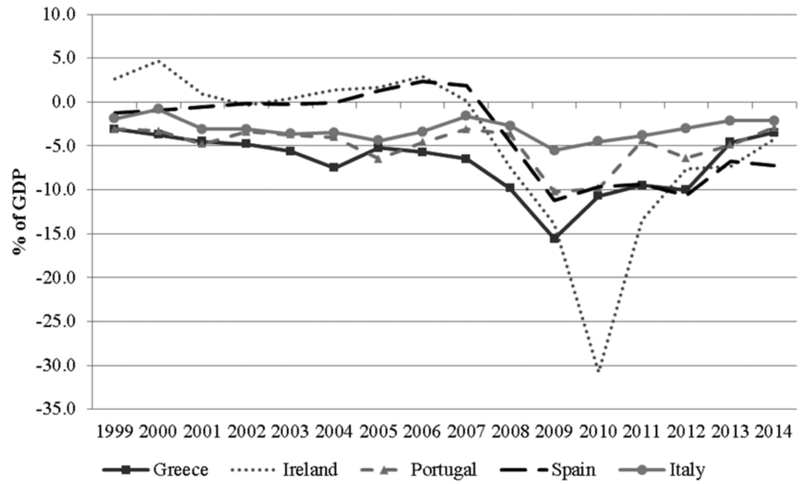


Figure 1 – Public fiscal balance in relation to GDP (%). Sources: Eurostat; 2013 and 2014 forecast EU Commission; own illustration.

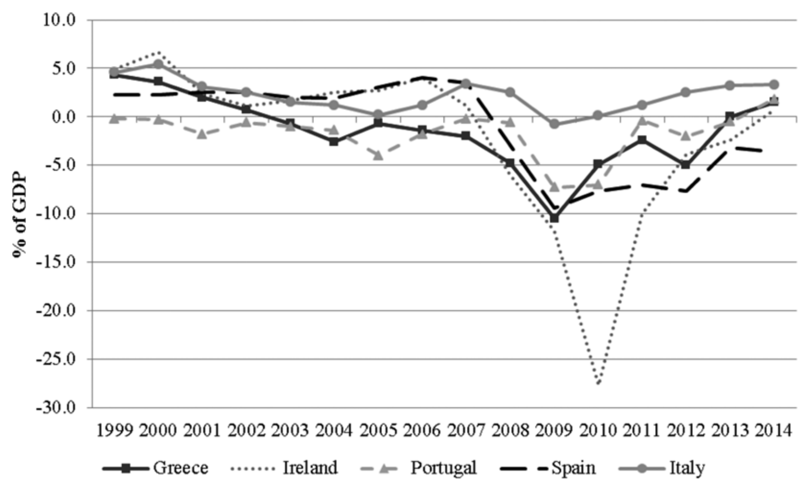


Figure 2 – Primary fiscal balance in relation to GDP (%). Sources: Eurostat; 2013 and 2014 forecast EU Commission; HIS.

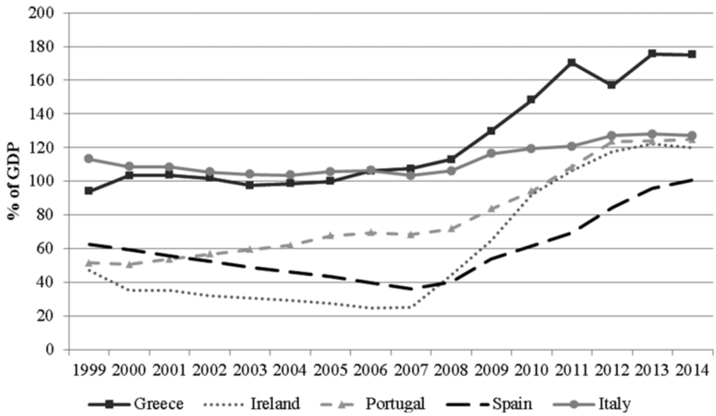


Figure 3 – Public debt level in relation to GDP (%). Sources: Eurostat; 2013 and 2014 forecast EU Commission; HIS.

Figures 4 to 6 document the adjustment which has been achieved in terms of international competitiveness and the resulting re-balancing of the current accounts. In order to put the adjustment in the crisis countries into perspective, the development of the two most competitive economies in the euro area, Austria and Germany, is also depicted. Between 1999 and 2007, the crisis countries experienced a real appreciation as measured on the basis of the trade-weighted real effective exchange rate with respect to 36 trading partners (Figure 4). Their international price competitiveness deteriorated sharply during this period. The appreciation was particularly pronounced in Ireland and in Spain with 22% and 20%, respectively. The other countries experienced more moderate increases of their real exchange rates by 3% to 7%. The development of the real effective exchange rate is in part determined by the development of the nominal exchange rate of the euro. Since this movement of the nominal euro exchange rate is common to all euro area countries, it does not influence the relative price competitiveness of the euro area countries *vis-à-vis* the other Member States. Excluding the nominal effective appreciation of the euro between 1999 and 2007, Ireland and Spain experienced a real appreciation of 14% and 17%, respectively. Since the beginning of the crisis, all considered countries achieved a real depreciation. With 17%, the correction was most pronounced in Ireland. As Figure 4 shows, the loss of international competitiveness which the countries had incurred after the introduction of the euro until the outbreak of the crisis has already been largely corrected, except for Spain. As can also be seen, the countries could not improve their relative competitiveness compared to Germany, since Germany improved its competitiveness further in the recent past. In contrast, the relative real effective exchange rate of Austria remained more or less constant.

The real appreciation which the considered countries experienced between 1999 and 2007 was largely determined by wage increases in excess of productivity advancements. As Figure 5 shows, this resulted in a sharp rise of unit labour costs. The figure depicts the development of this indicator relative to the euro area average. In Ireland the rise in unit labour costs exceed the respective increase in the euro area average by as much as 20% until 2007. Since the outbreak of the crisis, all considered countries with the exception of Italy made significant progress in correcting this loss of price competitiveness *vis-à-vis* the other euro area Member States. Particularly in Greece, wage cuts have resulted in a remarkable correction of unit labour costs. Due to somewhat higher wage increases in Austria and Germany, reflecting the favourable labour market development in these two economies, unit labour costs increased relative to the crisis countries.

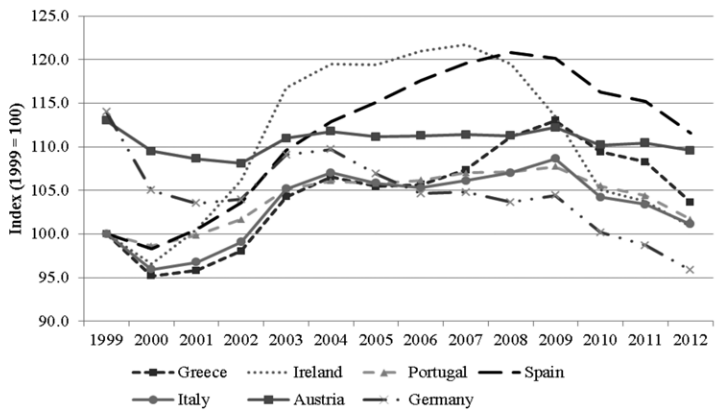
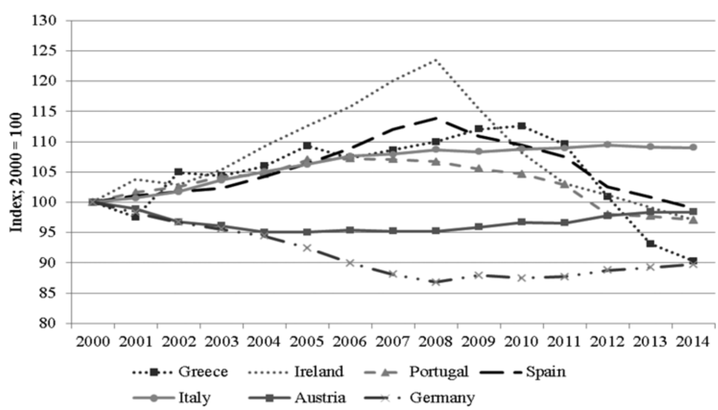


Figure 4 – Real effective exchange rate (on the basis of GDP deflators) (index, 1999 = 100). Sources: ECB; HIS.



Unit labour costs are calculated as compensation of employees divided by labour productivity. Labour productivity is defined as real GDP per employee.

Figure 5 – Unit labour costs, relative to euro area average (index, 2000 = 100). Sources: Eurostat; 2013 and 2014 forecast EU Commission; IHS.

In 2012, all countries except for Ireland had current account deficits (Figure 6). However, the extent of the deficits varied considerably between countries, ranging from just 0.7% in relation to GDP in Italy to 7.7% in Greece. After the introduction of the euro, the current account deteriorated sharply in all considered countries, except for Portugal which entered the euro area already with a sizeable current account deficit of almost 9% of GDP. The largest current account deficit was reached in 2008, i.e. during the financial and economic crisis. Since then, the countries managed a remarkable improvement of their current accounts. The real depreciation brought about by wage and price restraints are bearing first fruits. However, the pace of adjustment varies markedly between countries. While Ireland achieved already surpluses, the current accounts of Greece and Portugal are still deep in negative territory. However, according to the forecast of the European Commission, in 2013 and 2014 all countries except for Greece should achieve current account surpluses or, in the case of Portugal, at least a balanced current account. Germany was able to maintain its current account surpluses in the recent past, indicating its high international competitiveness which goes beyond relative prices, since the German, as well as the Austrian economies are specialised on the production and export of high-quality investment goods which are highly demanded on the world markets.

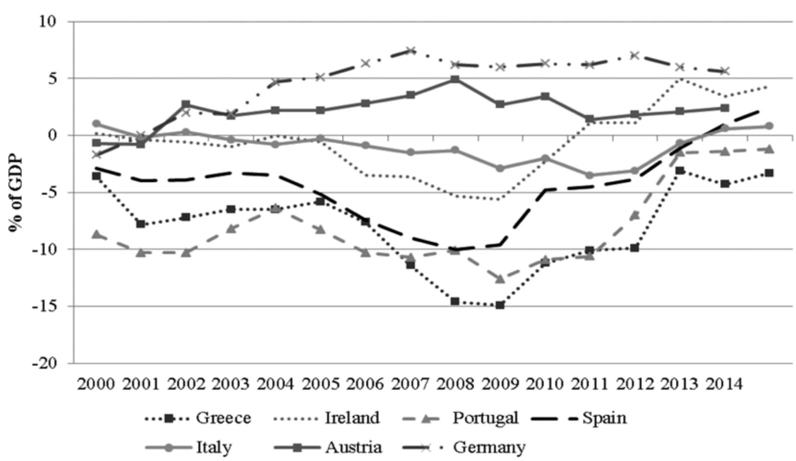


Figure 6 – Current account balance in relation to GDP (%). Sources: Eurostat; 2013 and 2014 forecast EU Commission; IHS.

Clearly one main reason for this improvement was the collapse of domestic demand and hence of imports due to deleveraging of private households and companies, very high unemployment and the negative impact of the necessary fiscal consolidation measures on demand. But in addition to decreasing imports, rising exports also contributed to the improvement of the current account. As Figure 7 shows, exports declined sharply in the worldwide economic crisis, but meanwhile started to recover. In Ireland, Portugal and Spain real exports of goods and services already exceed their pre-crisis levels.

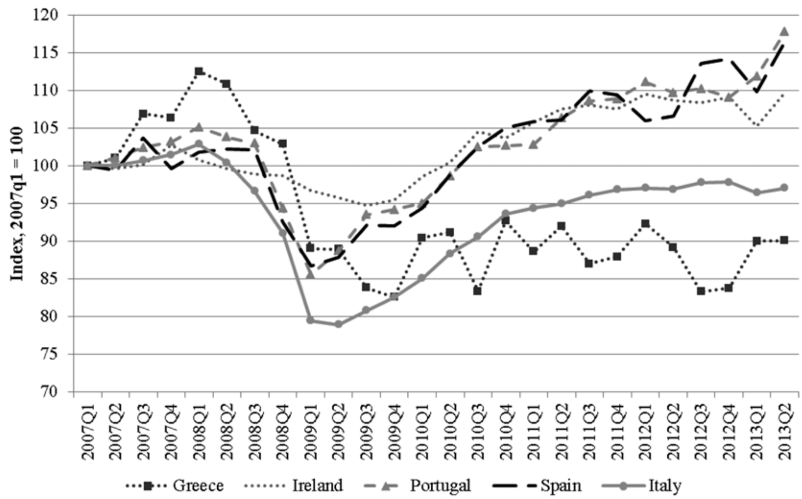


Figure 7 – Export development since 2007. Sources: Eurostat; IHS.

The financial crisis revealed clearly that many banks in the euro area were too weakly endowed with equity. Due to the recession, more and more loans to the private non-financial sector became non-performing. As Table 1 shows, e.g. in Ireland the share of non-performing loans soared from below 1 percent prior to the crisis to almost 19 percent in 2012.

Table 1 – Bank non-performing loans in % of total loans.

	2000	2007	2008	2009	2010	2011	2012
Ireland	1.0	0.8	2.6	9.0	8.6	16.1	18.7
Greece	12.3	4.5	5.0	7.7	10.4	14.4	17.2
Spain	1.2	0.9	2.8	4.1	4.7	6.0	
Italy	7.8	5.8	6.3	9.5	10.0	11.7	
Portugal	2.2	2.8	3.6	4.8	5.2	7.5	9.0
Austria	2.4	2.2	1.9	2.3	2.8	2.7	2.7
Germany	4.7	2.7	2.9	3.3	3.2	3.0	

Source: World Bank, World Development Indicators.

Due to the systemic relevance of banks and the importance of a stable credit supply to the private sector, governments had to re-capitalise banks, further raising budget deficits and public debt levels. As a consequence, the new regulatory framework initiated at the European level requires that banks have to hold more equity. These new regulations have already resulted in considerable improvements in the capital endowment of European banks, as Figure 8 shows. However, the recapitalisation of European banks is not yet completed. The OECD estimates that the current capital shortage amounts to around 400 billion euro (4¼ percent of euro area GDP) if the euro area's largest banks were to move to a standard of a 5 percent tier 1 capital ratio. According to the OECD, this is not just a problem for banks in the periphery, but there could be large capital needs in the major euro area countries (OECD 2012).

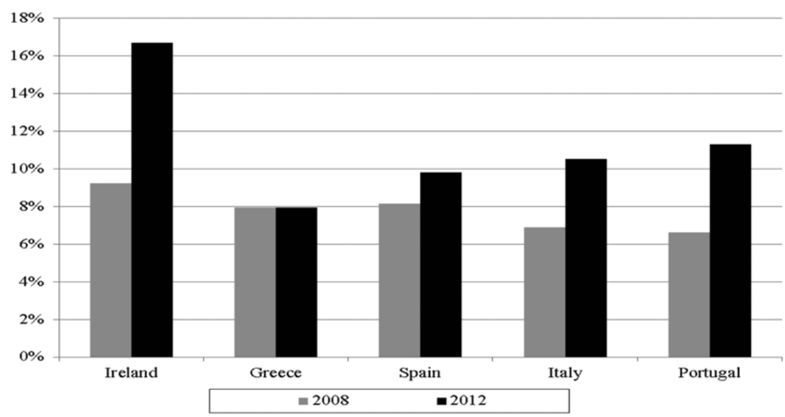


Figure 8 – Tier 1 capital ratios of banks in selected European countries. Source: European Central Bank.

The adjustment of international price competitiveness, but also regarding the banking sector reforms, has strengthened the confidence of international investors into the financial and macroeconomic stability of the peripheral euro area countries. This is visible in a reversal of capital flows. As an example, Figure 9 shows that the withdrawal of bank deposits by non-residents in the banks in the peripheral countries recently started to reverse.

The improvement in the economic and sovereign debt situation of the peripheral countries led also to a reduction of the Target liabilities of these countries (Figure 10). During the crisis, the Eurosystem compensated the interruption and reversal in capital flows by shifting refinancing credit among national central banks. The increase in Target liabilities is a direct measure of net payment orders across borders, i.e. of the portion of the current account deficit that is not counterbalanced by capital imports, or, equivalently, the sum of the current account deficit and net capital exports. Indirectly, they also measure a country's amount of central bank money created and lent out beyond what is needed for domestic circulation. The reduction of these liabilities can therefore be regarded as an indicator for the increase of private capital flows to the respective countries.

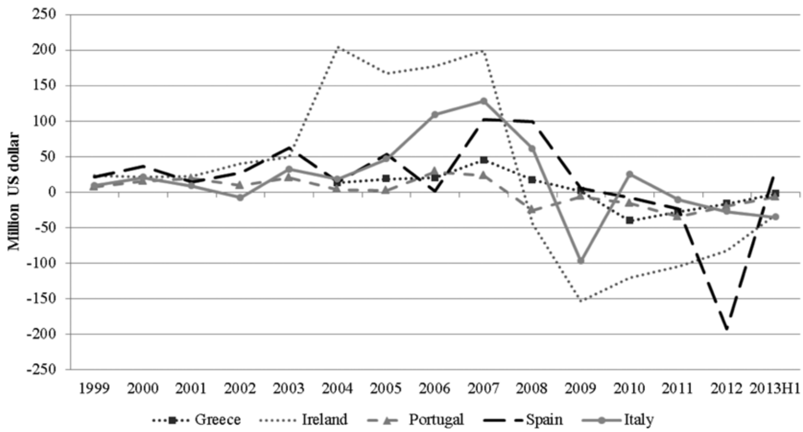


Figure 9 – Bank deposits of non-residents in banks in selected countries. Sources: Bank for International Settlements; IHS.

As the previous analyses have shown, all considered countries have made progress in the adjustment towards sustainable public finances and a competitive economy. However, the speed of adjustment as well as the achieved progress varies considerably across countries. Among other factors, the extent of the accomplishment depends on the starting point of the reform progress. At least the real effective exchange rate has in the meantime depreciated in all considered countries, and this improvement in international price competitiveness has resulted in a sizeable decline in the current account imbalances. This was not only due to recession-induced shrinking imports, but also to rising exports. The recapitalisation of banks in the crisis countries has also made progress. The need for strengthening the capital basis of banks is underscored by the evidence that the de-leveraging process of banks in the peripheral countries has contributed to a fall in longer-term loans flows which became negative in the second half of 2012. Supply factors contributed significantly to this development. This has also international repercussions since banks are often the dominant source of funding in emerging and developing economies, and international banks in general and European banks in particular play a key role in their financial systems. Therefore, the impact of European bank deleveraging and tighter credit conditions is directly transmitted to the rest of the world (Feyen, Gonzalez del Mazo 2013).

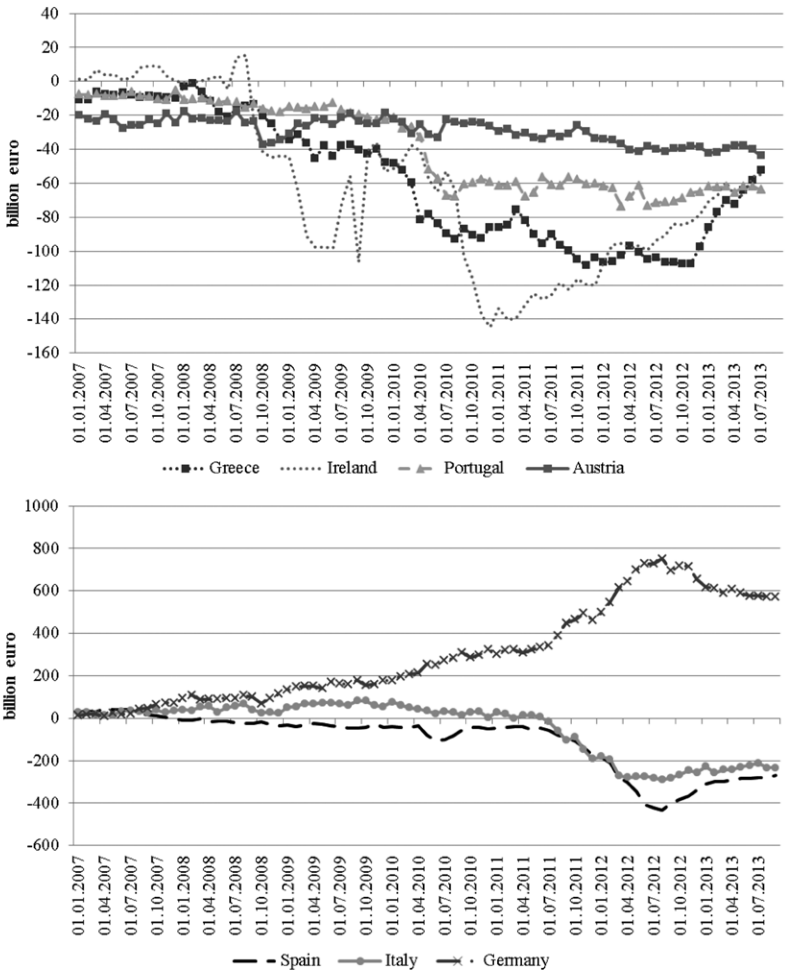


Figure 10 – Balances in the Target2 system of the ECB. Sources: Ifo institute; IHS.

Differences in the adjustment progress are considerably determined by divergences regarding regulations and institutions. It is striking that among the considered countries, Ireland, the country with the largest progress in the macroeconomic adjustment, is ranked highest regarding competitiveness in the competiveness indicator of the World Economic Forum (WEF). This ranking is also reflected in the ease of doing business indicator of the World Bank. At the other end of the country spectrum, Greece and Italy are ranked at the bottom of all OECD countries, clearly indicating their deficiencies regarding structural change and institutional development (quality of legal system, tax administration, bureaucracy, competition reducing entry barriers and protection of rents, corruption, shadow economy etc.).

It can be concluded that the adjustment process is tough and slow, and the road towards sustainable public finances and macroeconomic balances is long and full of conflict. The extent to which restrictive fiscal policies have contributed to the recession in the crisis countries, i.e. the size of the fiscal multipliers, has recently been hotly debated. Blanchard and Leigh (2013) argue that fiscal tightening is having a surprisingly strong negative impact on growth. On the other hand, the European Commission (2012) notes that fiscal vulnerabilities, leading to sharp increases in borrowing costs and tightening of credit conditions, were the main reasons for the unexpectedly large negative effects on GDP of the current fiscal adjustments. Since interest rates for loans to the private sector are correlated with government bond yields, rising government bond yields in the crisis translate to higher private sector borrowing costs with negative impacts on investment and private consumption. While fiscal consolidation and deleveraging are necessary, the negative macroeconomic and hence social effects might be cushioned somewhat by reducing the speed of adjustment. However, such a slowdown of the reform process bears the risks that financial markets punish the associated additional borrowing needs from the market by demanding again higher interest rates. It is possible that there is some room for flexibility in designing the time path for fiscal adjustment, but these countries would have to proceed very carefully (Honkapohja 2013).

In all countries unemployment has reached very high levels. This not only implies the risk that cyclical unemployment becomes structural with negative effects on the growth potential, but also endangers political support for the painful but necessary adjustment measures. Political turmoil and protests which occurred repeatedly in the crisis-struck countries show very clearly that the continuation and future success of the adjustment progress hinge on a significant improvement of the labour markets. Furthermore, the adjustment progress is until now only visible in flows such as current account balances as well as public and private financial balances. Stocks like public and private sector debt levels will in most cases grow further, since their reduction requires not only lower deficits, but also surpluses.

7. Conclusions

When the euro was introduced, the exchange rate risk was eliminated, resulting in very low interest and in overly expansionary demand, price bubbles and increasing private and public indebtedness in the euro area periphery. In these countries, wages grew much faster than productivity. As these wage gains translated into high price increases, international price competitiveness was eroded. Together with low interest rates and credit financed domestic absorption, current account imbalances built up. Furthermore, governments were confronted with low financing costs of their budget deficits and easy access to credit. Given low credibility of the Maastricht rules, some countries relaxed on fiscal discipline. In the wake of the financial and economic crises, financial markets re-assessed the risk of sovereign default, given high public debt levels or other sources of public sector risk; hence these countries were confronted with increasing risk premiums and ultimately had to accept financial assistance by the international community, subject to strict and painful fiscal and structural reforms.

In the meantime, economic adjustments in the crisis-struck countries have resulted in improved international price competitiveness and lower public deficits. In many countries recapitalisation of the banking sector has made progress, contributing to more financial stability and lower vulnerability. However, the road to full adjustment is tough and slow. Fully re-gaining sustainable public finances and correcting macroeconomic balances will still take considerable time. If the high unemployment in these countries which results from the adjustment-induced recession is not reduced soon, it will endanger the growth potential and negatively affect political support for the painful, but necessary adjustment measures.

Reforms undertaken since the outbreak of the crisis not only involve macroeconomic and fiscal rebalancing at the level of the Member States. Equally importantly, the EU created several new institutions and strengthened the mutual economic surveillance in the Member States. Some of these new institutions involve the transfer of national responsibilities to the European level. Any decision about centralisation or decentralisation in Europe – as currently regarding the banking union – should observe the principle of subsidiarity which is laid down in the European Treaties. According to this principle, decisions should be taken closest to the citizens since needs and preferences are best known at the most decentralised level. On the other hand, some areas with substantial spillovers across countries require regulation at the central level. One important example is the banking union since many banks operate in many different Member States. In such cases where the whole is more than the sum of its parts, central regulation is necessary to internalise cross-country externalities.

It can be concluded that the future of the euro area will be determined by continued national reform towards fiscal balance and increased competitiveness and growth, continued recapitalisation of the banking sector, and the completion of the banking union with central regulation and oversight including bankruptcy rules for large banks. Apart from the design and implementation of the banking union, further reforms should aim at cutting the vicious link between governments and banks. Public debt should be treated with their appropriate risk in calculating equity requirements of banks (Basel III rules). A zero risk weight induces banks to hold too much local public debt, making them overly exposed to sovereign risk of their home country. This problem is made more severe by the lack of a euro area wide safe asset. Creating such an asset along the lines of Brunnermeier *et al.* (2011) would largely eliminate the risk of expectations driven capital flight and distortions in capital allocation in the euro area.

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Eurozone Crisis: Possible Future Scenarios

Lubor Lacina

1. Introduction

The Eurozone crisis is not the first crisis in the history of the European integration project. It is clear that there must be strong motives – achievements, benefits – that have always carried the European Union through crisis periods and prevented its disintegration or splitting. So far, as soon as a crisis is over, or even in the course of a crisis, the number of member countries has increased, from the six founding countries to the current 28 Member States, and the integration process has been expanded, from a customs union to today's economic and monetary union.

While some EU and Eurozone countries have managed to successfully withstand the financial and economic crisis after 2008, other States are still up to their ears in problems. Most of the EU countries (including key players like France and Italy) expect painful reforms in the name of fiscal policy recovery and greater competitiveness. Such steps, however, hurt many citizens, and if they arrive sanctified by Brussels it is not difficult to foresee another avalanche of 'Europhobia' or Euroscepticism. This prompts the following question: what motives can the advocates of European integration rely on during the ongoing Eurozone crisis? Are those motives strong enough to protect the EU/Eurozone from growing Europhobia, Euroscepticism and possible disintegration?

2. The Eurozone crisis and its possible consequences

Periods of economic crisis have always been and continue to be associated with the slowdown of the integration process and the increase of 'Euro-centrifugal' or Eurosceptic tendencies in Member States. It is true, however, that the European project has always overcome crisis periods, remaining at-

Max Guderzo and Andrea Bosco (edited by), *A Monetary Hope for Europe: the Euro and the Struggle for the Creation of a New Global Currency* ISBN 978-88-6655-965-8 (print) ISBN 978-88-6655-966-5 (online)

tractive for other candidate countries and capable of further strengthening of cooperation for integration (fiscal union, banking union, capital market union). Can we expect a shift towards closer cooperation among EU Member States in the near future too? Or in this case will a process of European disintegration begin, either geographical (Member States' withdrawal from the EU) or functional (return to simpler forms of cooperation: internal market, customs union)? The EU, Member States and voters will therefore have to decide whether the sense of privilege stemming from the creation of a large entity with a significant negotiating position in the globalizing world will prevail, or whether a call for greater domestic autonomy and decision-making power on significant issues without the influence of a transnational entity will win, as in the UK in/out referendum.

Even in the times of economic growth, low unemployment and stable macroeconomic environment some national politicians attributed their domestic economic problems to EU policies (and later, since 1999, to the common currency or, more precisely, to the European Central Bank's overly restrictive monetary policy). As the length and depth of the current recession increases, the frequency of such Eurosceptic views has also increased. Blame for domestic economic problems is often laid on the common currency or categorically on the EU as a whole. Hence, it is only a matter of time before citizens and politicians (both respectable and populist) start asking questions about the costs of a continued EU or Eurozone membership[1]. The position of parties grounding their programmes precisely on criticism of the negative effects of European integration on domestic economies has been strengthening in national election results since 2008. The success of eurosceptic-oriented parties was visible in the results of the European Parliamentary elections of May 2014.

The ongoing crisis of European integration is a test of the newly adjusted EU primary law, regulated by the so-called Lisbon Treaty. Under this treaty, after long discussions among Member States, a provision establishing the right of a Member State to withdraw from the EU appeared for the very first time. Article 50 of the Lisbon Treaty[2] clearly states not only Member States' right to secede from the Union, but also outlines the process to be followed to do so. Will this crisis, partly as a result of the legal right to renounce membership, also be the first to lead to the withdrawal of certain Member States, or to splitting the EU into a 'two-speed' union?[3]

[1] These discussions have already begun in the UK (Brexit) and Greece (Grexit).

[2] «A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union».

[3] We can observe that the Eurocrisis already divided the EU into two parts: the Eurozone countries and the rest of the EU. Some of the decisions were made out-

The length of the current crisis (economic recession) and the ability to restore previous economic growth will be a significant, if unknown, variable. The longer the crisis, the greater the risk of Eurozone disintegration or the withdrawal of some countries from the EU. For example, in 2014 the Greek economy was already only 70% of its pre-crisis level. Beyond this, the decline continues as does the drop in living standards of the Greek population. A number of large economies (Italy, France) have long been shuffling their feet, recording no growth. Unemployment in Greece and Spain exceeds the 25% threshold. On the other hand, however, there are countries (Germany, Estonia) that have managed to rapidly restore their economies to a growth phase, thanks to structural reforms implemented prior to the crisis (Germany-Hartz I-IV), or as in Estonia during the crisis (wage cuts, fiscal restrictions), in this case even at the cost of a temporary, yet significant, drop in living standards. Nonetheless, in general, many fear that the EU economy as a whole will never again return to pre-crisis growth trends.

There are several possible future scenarios of economic development. In the first, there is only a temporary decline of potential output when compared to the pre-crisis trend, but after a certain time the pre-crisis level is reached again. Economic loss is determined by the length and depth of the deviation of potential growth from a long-term trend. In the second scenario, decline in growth remains at this lower level on a long-term basis (for example, due to the inadequate response of economic policy: the unsolved problem of maintaining the stability of the financial system). At the same time, however, the unemployment rate stabilizes at the level reached at the end of the recession. A long period of stagnation is therefore associated with all the negative consequences of high long-term unemployment. In the third scenario, the most pessimistic, economic crisis leads to decline in potential growth, with the growth gap[4] increasing even further over time. In connection with this, unemployment may rise.

Nevertheless, reality can be even more complicated. Countries such as Germany, Ireland and Estonia manage to restore the growth of their economies a lot faster because of more flexible labour markets and braver political decisions: past or present structural reforms. In contrast, other economies (such as Greece) are falling into a vicious circle of reforms, savings and further decline in living standards. The heterogeneity of the Eurozone is increasing again. Some shocks are becoming permanent. The dissatisfaction of citizens is growing, not only in Greece, Portugal, Spain or Italy, but even in countries in better economic conditions, such as Germany, Finland or

side the EU legal framework. The Eurozone itself is divided into core and periphery (North and South). The migration crisis divided the EU into old and new member countries (West and East).

4 Growth gap is defined as the difference between potential and actual product. Thus, it shows the volume of product that might have been produced but was not.

Slovakia, that have become the 'sponsors' of problematic countries in the system of stabilization mechanisms.

There are several future scenarios and possible approaches to solving the crisis. These range from a deeper political integration towards fiscal union to the collapse of the entire Eurozone, the return to national currencies and the potential start of disintegration of the entire European project built up over the last 65 years.

The most debated scenario is the disintegration of the EU, meaning that some countries will withdraw from the Eurozone or the EU. This scenario will materialise if several or most current Eurozone members jointly come to the conclusion that it is the euro which prevents recovery from the crisis and it would therefore be advantageous to return to national currencies. In this case, it might perhaps be a joint political decision made by top representatives of EU Member States, which would be kept secret as long as possible to give the Eurozone countries enough time for technical preparation for a return to national currencies. Although it is Greece that gets mentioned most often, there are much greater concerns about the collapse of big economies such as Italy, Spain or France. Nonetheless, it should be noted that the situation calmed down significantly in 2013 owing to measures approved by the European Council, the European Commission and the European Central Bank. These included the creation of the European Stability Mechanism, the building-up of the banking union and the strengthening of supervision over fiscal stability (Two Pack, Six Pack, Fiscal Compact and European Semester), plus the ECB President's statement that the Bank would do 'anything' to save the euro. Many economists have also begun to point out that without the euro there would probably be much greater instability as a result of speculative attacks on individual national currencies (the policy of competitive devaluations: beggar-thy-neighbour policy). Countries with low competitiveness (huge deficits of balance of payment current account), budget deficits and high debt would be particularly hard hit by the major depreciation of newly-established national currencies, major increase of inflation and inability to pay obligations, all of this immediately following exit from the Eurozone. In any case, the withdrawal from the Eurozone would have to be made as a one-shot step without consulting other member countries. In addition, all preparations for the changeover from the euro to national currency would have to be conducted in secrecy in order to minimize economic losses[5]. It can be assumed, however, that no government would take

[5] The process of replacing the single currency with a national currency would indeed be associated with costs similar to those involved in the introduction of the euro (the costs of printing banknotes, coins, repricing all items, changing accounting systems, etc.). The fact is that while the euro changeover was under preparation for several years, a changeover back to the national currency would have to be done with minimum preparation, undoubtedly bringing with it a host of complications for national

such risky measures without consultation with other Eurozone members, the European Commission and the ECB. The UK can serve as an example of a country where potential withdrawal from the EU has been debated for several years. The British government can rely on detailed studies, updated on a regular basis, about the potential impact of state authority on individual areas and about Britain's position within the EU and in the entire global economy. Before any final political decision, a nationwide referendum – an exceptional instrument in the British political system – is planned. And the UK does not even use the euro; but even so, balancing of benefits and costs of leaving the EU is challenging.

Another possible scenario of the evolution of the economic crisis could be called the 'Japanese way'. The economic downturn stops after a while and remains at this lower level for a long period. The term 'hockey stick effect' is used for a similar economic development. At first the economy records a steep decline in production. After reaching the bottom, the economy does not improve immediately but stays at this lower level for a long time. This condition is usually the result of the ineffectiveness of monetary policy which exhausts all its instruments in the period of decline, at some point becoming ineffective. Interest rates announced by the central bank approach zero. Real interest rates acquire negative values. The ineffectiveness of monetary policy can result in an extremely proactive fiscal policy and the overall growth of government debt. Japan is now one of the most indebted economies of the developed world, with government debt reaching 200% of GDP.

The inability to restore pre-crisis economic growth reduces the standard of living on a long-term basis, and unemployment with all its negative consequences will stay in double digits in some countries. Society will step up pressure on national political leaders and the number of radical proposals to solve the crisis will increase.

In another scenario, the triggering role in the entire collapse of the Eurozone might be played by Germany, should German officials assess their country's continued membership in the group as too costly and risky. Although this variant of Eurozone crisis outcome seems unlikely, it is not entirely impossible. Already when preparations to establish the economic and monetary union began, it was clear that the entire project could take place only if Germany participated. It can therefore be assumed that Germany's decision to return to the mark would lead to the disintegration of the entire Eurozone. From Germany's point of view, the trigger mechanism

economies. On the other hand, it should be noted that even after the introduction of the euro, the dimensions of the national central banks operating in all Member States are much the same as they were before the transfer of decision-making powers on monetary policy to the ECB. Each country thus possesses sufficient professional and technical capacity to restore the national currency and formulate autonomous monetary policy.

might not be so much its own poor economic development but rather the requirement of lagging countries to obtain financial resources from more prosperous EU economies. The truth is that the newly-established German currency would probably appreciate against the rest of the Eurozone or newly-introduced currencies. Yet, this also occurred in the period following the collapse of the Bretton Woods system of fixed exchange rates, and the German economy still managed to maintain its competitiveness by controlling the growth of nominal wages and productivity. The German economy has not lost this ability even in the early twenty-first century, and thus it can be assumed that the impact of currency appreciation on the country's competitiveness would be only temporary. It should be stressed that one of the fundamental values in the European integration process, the principle of solidarity among countries, has reached its limits. The willingness of both the rich Member States and some new ones (for example, Slovakia) to use a portion of their tax revenues to assist other European economies has been gradually diminishing.

At first glance, an elegant solution to the problem of countries suffering from high debt and an increasing risk of being unable to repay would be to decrease the value of the debt via real reduction through faster growth of price levels[6]. With a fixed interest rate of the instruments financing public debt, increased inflation would lead to a decline in the real cost of debt service. In this way, the likelihood of periphery countries going bankrupt could be reduced. At present, however, the situation is completely different. Central banks are independent of governments, which in a monetary union do not have the control over the central bank and its monetary policy that they used to have. The Eurozone inflation target is anchored within EU legislation (Statute of the ECB), and any change requires the unanimous approval of all EU Member States. As a first step, they would have to agree upon a relaxation of the inflation target, especially Germany, which identified adherence to a stable price level as one of the basic conditions for entry into the economic and monetary union. This requirement has a very pragmatic explanation. During the second half of the twentieth century Germany achieved one of the highest living standards in the world. It is also home to one of the most rapidly aging populations. German citizens' demands on their own political representation are therefore unambiguous. It is not necessary to increase the standard of living any further, but the *status quo* has to be maintained or, in other words, a stable real value of accumulated wealth must remain a

[6] This solution was used in the past to solve the situation of unsustainable debt level. After losing wars, kings would realize that their coffers were empty and debts accumulated in the course of the war exceeded the economy's ability to repay them. The usual solution was to withdraw from circulation gold coins issued by the king (usually with a portrait of the ruling monarch), melt them down and return them back into circulation with smaller gold content, which is none other than inflation.

priority[7]. This objective would be threatened by the acceleration of inflation. Thus, considering Germany's position within the Eurozone, the notion of increasing the inflation target of the Eurozone seems unrealistic[8]. The problem of countries with high debt service costs will have to be solved by other means. Last but not least, it is also worth noting that solving growing debt by 'discreet' inflation is essentially nothing more than a subtle rip-off of all citizens who have increasingly worthless money left in their wallets while prices all around them keep rising. An alternative to the 'inflation scenario' is faster economic growth which naturally decreases the proportion of debt to GDP ratio. As we have already mentioned, the limitation of this alternative scenario is a low or, in the case of Greece, even a negative growth of the economy in the last few years, combined with an estimated even lower potential growth in the future.

The European Commission, the European Central Bank and the Member States acting jointly in the EU Council and the European Council were startled by the dynamics of the crisis. Debating on resolutions through to the early hours of the morning by top EU and Eurozone representatives has become commonplace since 2008. Especially in the early years of the crisis, a favourite tactic adopted by European Commission representatives was that of an 'ostrich' burying its head in the sand and ignoring the reality of the outside world. The European Central Bank decided to abandon its responsible monetary policy of maintaining low and stable inflation, 'releasing' a huge amount of money into circulation in several steps, entailing the threat of future inflation. Neither the European Commission nor the European Council found the courage to carry out unpopular measures, which is why the International Monetary Fund was invited to help since it had past experience with dealing with both debt and currency crises. The IMF recipe has not changed much over time and is based on a carrot-and-stick principle: «We will help you, but you must first show sufficient self-sacrifice and commitment of your own». In other words, help for States and governments lacking financial resources for pension payments, state employee salaries and the very running of a State is subject to relatively radical savings in government spending.

7 German pensioners no longer want to be richer, but they want the wealth that they accumulated during their working lives to maintain its real value until the end of their lives. And from this perspective, the greatest danger is posed by inflation. Inflation negatively impacts the real purchasing power of accumulated assets (for example, fixed-income bonds), but also fixed income such as continuously disbursed pensions (be it by a State or a pension fund).

8 Nonetheless, Germany can partly show its solidarity with the countries hit by the debt crisis by, for example, government, trade unions and employers agreeing on a faster growth of nominal wages. This may ultimately accelerate the growth of prices (inflation and cost of production) in the German economy and indirectly increase the competitiveness of German business partners.

It is evident that Eurozone Member States cannot restore their competitiveness and economic growth by currency devaluation, as many of them used to do in the past. It is not technically possible to nominally depreciate the Greek euro against the same German euro[9]. Reducing nominal wages and prices (so-called internal devaluation) is the only path for at least partial recovery of competitiveness in countries using the common currency. In the long run, however, it is a very dangerous phenomenon. If governments are simultaneously forced to reduce their spending, the aggregate demand of the economy significantly decreases. This will then result in a decline in economic performance: recession. A good example of the limited possibilities of economic policy to cope with a deflationary development is the situation of the Japanese economy over the last 20 years. Japan's Central Bank keeps interest rates near zero in the long term and applies a policy of quantitative easing. Moreover, an expansive fiscal policy has made Japan a country with one of the highest government debts ever. Yet, Japan has been failing to kick-start economic growth. The combination of pressure to reduce nominal wages, efforts to restore public finances and the ineffectiveness of common monetary policy might therefore become one of the factors triggering pessimistic scenarios of potential product development: long-term decline or significantly slower growth of economies than in the pre-crisis period. In this scenario, long-term unemployment would remain high[10], heavily burdening state budgets, increasing social tensions and testing member countries' willingness to stay in the Eurozone.

One of the real threats hovering over the Eurozone since 2008 has been a concern that, as a result of the ongoing economic crisis, a country with a high debt may not be able to refinance its debt service and may therefore declare insolvency at some point. This threat was fulfilled in 2010 when the Greek government was forced to ask for financial help due to rising interest rates on financial markets combined with the ongoing recession of the Greek economy. Yet, current EU legislation forbids the European Central Bank and Eurozone countries from participating in any way in the bailout of such economies[11]. The financial collapse of one economy may, however, undermine the credibility of the entire Eurozone in the eyes of financial markets and thus have a negative effect on all Member States in the form of increasing risk premium. Therefore, despite legal restrictions, the EU and the Eurozone Member

[9] In the case of countries of limited openness such as Greece, even the devaluation of currency will have only a marginal effect on competitiveness, growth of exports and consequently on economic growth.

[10] For example, unemployment in Greece or Spain has already exceeded 25%, with unemployment among 18-25 year olds amounting to over 50%.

[11] However, the ECB has instruments which can be used, and have already been used (LTRO operations) to protect national banking systems from the danger of lack of liquidity.

States have been looking for an option that would make financial assistance to the affected economies possible. The objective of this assistance is to protect the credibility, or stability, of the monetary union. However, even this scenario has a number of limitations, in addition to legislative barriers. The common EU budget has a limited size (about 1% of gross national income of all EU members) and, except for the European Globalization Adjustment Fund (about €500 million per year), does not have mechanisms that might support the financial situation of member countries with rising deficits and debts. Financial resources redistributed through the EU budget are therefore insufficient and additional necessary resources must be found at national level, i.e. in national budgets, outside the existing EU budget. Another important limitation is the amount of resources that would have to be found. It is conceivable that Member States, together with the IMF, would be able to collect sufficient financial resources to help small countries such as Greece, Portugal or Ireland. This, after all, has already happened. However, what if it were necessary to gather resources in the event of public budget collapse in countries such as Italy or Spain? In that case, even financial resources in the order of magnitude of hundreds of billions of euros would not suffice[12]. Another major constraint is the support of public opinion for such an action. It is, for example, very difficult to explain to the citizens of Slovakia why they should give their money to Greek or Spanish people. Moreover, it is hard enough for national-level politicians to find savings in their budgets to stabilize their own public finances. Finding support among the people – and even among politicians across the political spectrum – for the transfer of financial resources to other countries during the economic crisis thus appears highly unrealistic[13]. And, as already stated, from the perspective of a German voter the ECB policy of 'printing money' is unacceptable too.

The Eurozone crisis proved that European budgetary structures have not been designed to perform a stabilization function. The Eurozone was therefore not prepared to help member countries adjust to asymmetric shocks in the early stage of the crisis. This issue was addressed through Eurozone crisis management actions by creating stabilization mechanisms that did not have the form of a budget (EFSM, EFSF, ESM and redemption fund: one pillar of the banking union). The above-mentioned development reveals a need to re-

[12] At present, the European Stability Mechanism has up to €500 billion at its disposal, which experts still consider insufficient should it be necessary to provide financial assistance to Spanish or Italian economies. Estimates refer to up to triple the current sum if help to countries such as Italy and Spain were to suffice.

[13] The financial resources granted to Greece, Ireland, and Portugal also provoked quite a negative reaction, on the part of both opposition parties and public opinion. A good example is the fall of the Slovak government headed by Prime Minister Radičová in connection with the Slovak Parliament's voting on the provision of funding for the European Stability Mechanism.

think and redesign fiscal stabilization mechanisms in the Eurozone, since individual Member States fail to implement successful stabilization policies. All federations and monetary unions have substantially bigger federal spending than the EU, where only 2% of public spending is performed at supranational level. Ratios in analysed federations range from 35% of total social security spending in Canada to 67% in Germany. In general, the biggest portion of expenditure is focused on the elimination of asymmetric shocks and takes the form of social transfers. The problem in the EU/Eurozone lies in the reluctance of Member States requesting financial support to submit decision-making on their budgetary policy to a supranational authority: EU institutions. Most countries are not willing to give up autonomy in decision-making on fiscal policy priorities (Kadidlo, Lacina 2015). Nevertheless, countries providing these financial terms make establishment of a fiscal (transfer) union conditional on transferring part of the decision-making powers in the area of fiscal policy to a supranational level[14], as is the case with monetary policy in a monetary union. The support for such a scenario, which would bring the EU closer to a federal union, is therefore much higher at the level of the main EU representatives (such as the European Commission and European Council Presidents) than at national level.

3. European integration as a long-term project – how to sell it to citizens?

For media strongly affecting not only public opinion (read: voters' attitudes) but also the opinions of politicians themselves, it is not sufficiently 'attractive' to describe the gradual steps and long-term achievements of the European integration process from its beginning. With regard to recent negative economic developments associated with the construction of the latest phase of the integration process, i.e. an economic and monetary union, analyses concerning the future development of the EU thus often present simplified conclusions about the need for the entire disintegration of the EU and a return to nation States. It is, however, actually quite simple to look at the other side: at the unprecedented success of previous phases of the integration process. In other words, the gradual building-up of the customs union and the single market associated with an increase in the living standards of all EU citizens. Benefits associated with the liberalization of trade as well as the possibility of free travel between countries are nowadays taken for granted both by the media and by ordinary citizens. Yet, they are one of the tangible and indisputable results of the European integration process and are not and have never been a matter of course in other regions.

[14] See, for example, the reluctance of some EU countries (the United Kingdom and the Czech Republic) to join the so-called Fiscal Pact, or the discussions about the introduction of new EU budget revenue in the form of a financial transaction tax.

The promotion of values and processes that we nowadays take for granted has always required complicated consensus-seeking among all member countries, their politicians and citizens. It is also true that the EU took over 60 years to achieve its present condition. A realistic observer of European integration ought to be reconciled to the fact that there has been and always will be a long journey from the original idea to its implementation, which calls for political compromises and the support of public opinion in the real environment of a democratic system.

Let us now make a short detour from discussion of the topic conducted on the basis of historical and economic arguments for a brief consideration of a technical-psychological nature. The late twentieth and early twenty-first centuries have been associated not only with the expansion of computer technology but also with access to a virtually infinite amount of information through Internet. As a natural consequence, people are overloaded with information from almost all over the world on a daily basis, so there is no space left for reflection on events and decisions that have taken place in the past but still affect the *status quo*. It is much easier to discuss details of events taking place on the other side of the globe (childbirth of an American celebrity, one hand in Bill Gates' pocket during a meeting with the South Korean president, etc.) than the historical context of the current state of the world, of Europe, or the position of a nation State or an individual. Again, nothing new under the sun, since philosophising has always been the pastime of only a small minority. This should not surprise EU leaders: they do not offer any substantial philosophy or ideas anyway.

The age of the Internet-connected world is governed by an aspect that strongly influences the perception of ordinary citizens. An individual's perception becomes much more oriented and sensitive towards current events, based on which s/he forms opinions even on such long-term processes as the integration of the European continent. At the same time, people are traditionally impatient when it comes to problems that require long-term solutions. In the early twenty-first century people have become accustomed to immediate responses by politicians to events as they arise. Yet the solution to the financial and economic crisis requires not only a rapid adoption of measures but also a search for comprehensive, systematic solutions, which are often unpopular among citizens – voters – too. It is also sometimes difficult to find support for necessary reforms across the political spectrum. Criticism of ruling parties' measures leads to the instability of political systems, early elections and a weakening impact of the measures implemented. The demand for populist solutions is growing, *inter alia*, because of current EU political leaders' inability to easily and clearly explain why and what they want and how they intend to achieve it.

It turns out that integration built on market and democratic principles is a much more stable model than integration based on 'one-party' rule and central planning of even the most basic activities. Thanks to the success of the

European integration process, the current generation can continue to enjoy one of the most stable periods in the long history of European civilization. The controversy surrounding the awarding of the Nobel Peace Prize in 2012 to the EU only illustrates how European and national politicians have failed to convince EU citizens of the stabilizing nature of the European integration process and its long-term contribution to the rise in living standards. Instead of opening up a discussion on the conditions for maintaining peace within the European continent in years to come, the Nobel Prize was exploited as an opportunity to express disagreement with the development of the economic situation in the Eurozone and dissatisfaction with the institutional structure of the EU. Surprising? Only partially, given the fact that EU leaders could not even agree who would personally receive the Prize at the Oslo ceremony. In policy circles, evidently, anything can be turned into a farce.

The Nobel Peace Prize reminded us that integration, which began in the 1950s, has demonstrated a success worth pursuing. Interest in membership was expressed in the past even by countries located partly or fully outside Europe, such as Turkey or Algeria. The European integration process has become an inspiration for emerging integration groupings in Africa, Asia and Latin America. An increase in the living standards of all social strata as well as the construction of social systems due to the co-creation of a peaceful environment and free market represent the resounding success of open cooperation among today's EU member countries, to which the European integration process has contributed significantly. Even countries remaining outside the process (for example, Switzerland and Norway) have gradually built special relationships with the rest of integrated Europe.

Up to the turn of the millennium, with the adoption and implementation of the Maastricht Treaty the European integration project was 'pushed' by politicians who had personal experience of the horrors of the Second World War: the so-called war generation. It is possible to give many examples of French and German leaders overcoming, by personal agreement, seemingly insurmountable obstacles (clearly visible at national level) during the bilateral negotiations that usually precede negotiations of the entire EU. Such politicians included not only Konrad Adenauer and Jean Monnet but later also, for example, François Mitterrand and Helmut Kohl. It was these politicians' personal experience of the consequences of the Second World War and their political courage that led to the reunification of Germany, agreement on the common currency project, and an unprecedented increase in the number of Member States effected by welcoming in 12 countries of Central and Eastern Europe. In addition to national leaders' ability to determine the direction of European integration within the European Council, one can also observe the highly important role played by strong personalities in the role of President of the European Commission (for example, Jacques Delors). Their departure from active political life and replacement by younger politicians who are only indirectly familiar with the conflicts of the first half of the twentieth century could be one of the factors explaining the slowdown of the European integration process and the reluctance to proceed further towards the establishment of a fully-fledged federation: a political union.

By contrast, the euro crisis caused a backlash among voters not only against the common currency project, but also against the whole process of European integration. In some countries seriously affected by the crisis, such as Greece for example, latent hatred towards Germany persisting since the Second World War has intensified again. In other countries the crisis, coupled with the need to implement unpopular reforms that reduce the standard of living, and the decline of economic growth has sparked debates about pros and cons of EU membership, as already indicated in previous chapters. Even more than 60 years after the end of the war, Germany is expected to pay off her debt for having provoked the largest ever global conflict with unprecedented human and economic losses. Germany is thus perceived as a country that has no right to tell other countries and their political representatives what to do to address debt problems, non-competitiveness and other negative effects of the economic recession. However, Germany itself has been implementing this policy for a long time and its economic strength continues to grow.

The Eurozone crisis has clearly shown how prevalent national interests and their favouring by national politicians hinder completion of the European integration process, i.e. the creation of a fully-fledged political union, a new State. The earliest sign came as far back as the 'game' surrounding the approval of the Nice Treaty. Then it was further demonstrated by the preparation and attempted ratification of the Treaty establishing a Constitution for Europe and consequently by the Lisbon Treaty. The EU political trappings and the EU institutions have not managed to 'sell' citizens the idea of continuing integration towards the creation of the United States of Europe, nor have they sufficiently explained the reasons for such a plan.

The Eurozone crisis exacerbated the sensitively-perceived relations between large and small Member States. Small EU Member States have long been concerned about being dragged along by decisions made and prearranged by large Member States. On the other hand, large Member States complain about the rigidity of decision-making in a circle of 28 different national interests and priorities. The reform of EU institutions so that they are able to make effective decisions with a growing number of countries is still only halfway through. Another problem hampering effective decision-making is the current model of two-speed Europe, with only 19 Member States (out of 28) using the euro. The need to solve the Eurozone crisis thus began to create parallel decision-making institutions, one for Eurozone countries and another one for the entire EU.

The economic crisis has reinforced the pragmatic behaviour of national politicians. They approach the evaluation of successes and failures achieved in the EU selectively. If any measures seem successful, they tend to 'sell' the achievements as mainly the result of their own initiative. By contrast, in the case of unpopular measures such as labour market or pension reforms, they tend to refer the need for reform to pressure coming from EU institutions. Thus, from the public's perspective, successes – positive integration – tends to be associated with the initiative of national governments, whereas failures are laid at the door of the EU. This in turn strongly influences the evolution of public support for the entire project of European integration.

It is very interesting to see how something that one tends to conceive as a highly bureaucratized and technocratic model is influenced in direct negotiations by the personal sympathies and antipathies of individual actors, or by their attitudes *vis-à-vis* the issue of the redistribution of power at national and supranational levels. As we have already mentioned, progress in the integration process was long driven by a generation of politicians who personally experienced the effects of two world wars. Their departure from the political scene brought a new dimension into negotiations among member countries. Compromises are no longer sought on the basis of personal relationships but rather on grounds of political orientation and attitude towards the European integration process.

An important role in the change of atmosphere in the negotiations was also played by the long-awaited accession of Central and Eastern European countries to the EU. In most cases, the position of the new Member States is based on a simple economic calculation of the costs and benefits associated with membership in the integration grouping, rather than on a genuine perception of the chance to participate in long-term cooperation in order to maintain peace. The Baltic countries provide an example of Member States' differing positions. In their considerations, the benefits emerging from membership of a democratic and market-oriented grouping always outweigh a simple profit-cost calculation. From this perspective, the example of the Baltic republics should serve as a model for all new member countries' political representations, as well as for their citizens. However, we also have to ask whether such reasoning can be emulated in the context of a completely different historical experience. Is not Baltic countries' euphoria apropos the EU an obvious and understandable contrast to previous painful Nazi and Soviet times? In the rest of EU countries such positive thinking does not come so easily.

The situation is interesting in the group of original member countries too. Despite remaining the driving force behind the European integration process, we can observe that Germany has over time lost some of the allies with which it used to create a strongly pro-integration camp in the past. The Netherlands and Austria were traditionally significant supporters of the European integration project, and Germany's allies. Their positions have been almost identical to those of Germany. But the same cannot be said about the rest of Germany's traditional allies. France, the second engine of the European integration process over the last 50 years, is increasingly assuming the role of an observer of changes rather than an initiator, mainly due to instability on the domestic political scene and recurrent problems with the dynamics of economic growth. The long-term alliance between the two countries sustained by personal relationships between leaders (see Mitterrand-Kohl) has not yet been restored and, given the different political and economic orientation of the two countries since Hollande was elected President, one cannot expect it to strengthen significantly in the near future either. Since the unsuccessful referendums on the Treaty establishing a Constitution for Europe, France has been 'shuffling her feet'. However, this is not to say that it is gradually moving into the Eurosceptic camp, but rather that it is relinquishing its former role as a country determining the direction of Europe's further unification. Another long-term ally of Germany used to be the Netherlands. As in the case of France, however, negative economic trends, instability in the political arena and the unsuccessful referendum on the Treaty establishing a Constitution for Europe weakened the country's unique position as Germany's special ally. We have already spoken about the relationship with Germany of peripheral countries (such as Greece, Italy, Spain, Portugal and Ireland), and no substantial shift can be expected in this area any time soon. A whole new chapter is the position of the United Kingdom, which in recent years has even been toying with the idea of abandoning the EU altogether.

When it comes to support for the integration process, an interesting situation can be found in countries with internal disintegration tendencies. It is useful to note that at a time when the potential withdrawal of some countries from the Eurozone (Greece, Cyprus) or the EU (UK) is increasingly under debate, a completely different development can be observed within the Member States themselves. Good examples could be Spain or the United Kingdom. Both in the case of efforts to separate the Basque country (Catalonia) from the rest of Spain and in the case of Scotland's desire to become independent from the UK, we can discern a clear ambition of these potentially new territorial units to join the EU.

Thus, although the recent crisis generally tends to lead to a decline in the support of politicians and citizens for the European integration project, an entirely opposite trend can be observed at regional level. On the notional balance pan, the number of countries that have joined the process of European unification in the past clearly outweighs those countries that jumped off the running train, or gave the leap serious consideration. Over more than 60 years, the number of Member States has grown from the original six to the current 28, with many other countries (for example, Macedonia, Serbia, Montenegro, Iceland, Turkey, Ukraine, etc.) seeking to obtain full EU membership. So far, Greenland[15] remains the only example of a country leaving

[15] In 1985, Greenland withdrew from the EC, which it used to be part of as a result of its status as an autonomous territory within the Kingdom of Denmark. Nevertheless, Greenland has continued its cooperation with the European Union on the basis of a customs union.

the European integration project, and the only country that has seriously considered termination of membership is the United Kingdom. The process of European integration thus still appears to be rather centripetal than centrifugal, with the gravitational force naturally changing throughout time.

4. Future motives and challenges of European integration

Since the outbreak of the financial and economic crisis in 2008, the decisions of EU institutions and the representatives of member countries have been driven by external circumstances rather than a clear strategy. Threats such as the collapse of the Eurozone or the withdrawal of some countries from the EU have been successfully averted so far, also due to the active role of the European Central Bank. Yet, they have been averted at what is (for the time being) an unknown price to be paid by all EU citizens in the future. Candidate countries are nonetheless still interested in access to the EU and the Eurozone. In July 2013, Croatia became the 28th Member State and other countries of former Yugoslavia (Macedonia, Serbia, Bosnia and Herzegovina, and Montenegro) are also interested in gaining EU membership.

During the Eurozone crisis, Estonia decided to replace its national currency with the euro. Latvia joined the Eurozone on 1 January 2014 and Lithuania on 1 January 2015. At the end of 2013, Ukraine too expressed interest in signing the Association Agreement with the European Union. However, the combination of Russia's political pressure, the EU's conditions for signing the Agreement and an overall lack of unity in the Ukrainian political scene caused a setback in the efforts to draw Ukraine closer to the EU. Politically, linguistically and culturally divided, Ukraine then underwent a series of bloody clashes between demonstrators and police forces, leading in the end to the fall of President Yanukovych's regime. The subsequent separation of the Crimea and conflict in the eastern parts of the country bolstered Ukraine's desire to take shelter under the wing of the EU, built on democratic principles.

The second group of non-EU countries is also worth mentioning: i.e. the countries that could join the EU but do not want to. Norway has not found the motivation; the wealth of raw materials and their exportation provide the country with above-average affluence, with the integration into the European Economic Area enabling it to make use of the single market principles as we know them in the EU. Also traditionally 'cautious' Switzerland is satisfied with a similar level of cooperation with EU countries, since it too is wealthy and does not wish to allow Brussels to influence it through primary and secondary EU legislation.

The globalized world makes ever-increasing demands on the 'sleepy' EU, daily testing its competitiveness and reminding it that the bizarre dimension of EU social systems is unparalleled in the world. A huge tax burden, gigantic contributions to social and health systems, combined with the effective im-possibility of letting surplus employees go, at least in in some EU countries: all these factors undermine the willingness of European and world companies to offer new (expensive) jobs. It often seems that the more absurd and rigid the labour market and the higher (artificially higher) the salaries not based on skills and efficiency on the employees' side, the higher unemployment is in the EU. Indolent citizens are, however, accustomed to the social safety net and fail to see that it will turn against them one day. Those who realised this got out of the crisis surprisingly quickly: the Germans, for example. An agreement between the government and the trade unions in the middle of the last decade froze salary increases for practically ten years. It managed to keep production costs and the prices of German products (the overwhelming majority of which were exported) relatively low, thus keeping them competitive in both the internal EU and the global markets. Currently Germany's exports are growing and the government in Berlin has already started talking about the preparation of surplus budgets. This is sheer utopia for countries such as Greece, Spain, Portugal and Italy, where employee salaries increased by approximately 30% from the introduction of the euro up to the beginning of the crisis in 2008. In parallel, of course, the price of their products rose too, leading customers all around the world to increasingly opt for German goods. Hence, it is true again that the gap between the rich North and the poor South continues to widen, with the crisis even intensifying this trend.

Globalization too has been showing the EU its dark side: it is increasingly necessary to 'compete' with those who are younger, more agile, competitive and not indolent (emerging markets). In this case, however, we are our own worst enemy, and so is the way in which the rampant social system has got out of hand and damaged our competitiveness and promptitude. It does not just protect us against poverty and misery, which was what we originally wanted from it, but also fails to motivate us to economic activity and often even discourages us from it.

It is paradoxical that it is the European Union that has been putting spokes into its own wheel. Whatever the scale and speed of global warming, EU countries will certainly not reverse the trend by themselves. The total greenhouse gas emissions of China and the whole developing world are likely to grow over the next few decades, because these countries do not possess the latest expensive technologies (which are 'cleaner'), or do not want to possess them, thus maintaining low production costs. Only absolutely exceptionally has economic growth been achieved while simultaneously reducing energy consumption (perhaps only in the case of Denmark, and even there only in the short term). Growing wealth almost always goes hand in hand with growing demands for barrels of oil and cubic meters of gas and is associated with this increasing discharge of so-called greenhouse gases.

Against the background of the growing competitiveness of the US (also thanks to new modes of hydraulic fracturing) and other world regions, EU countries are committing ritual suicide right in the world media spotlight. The struggle for 'greener' energetics has already cost the EU hundreds of billions of euros in direct and indirect costs and has increased the prices of electricity and other production inputs, including artificially-created emission allowances traded on an artificial market stacked with interventions by the European Commission. Certain economic sectors thus found themselves in a completely uncompetitive situation. The notion that instead of producing and exporting advanced products (turbines, locomotives, transport infrastructure, generally demanding products with high added value, know-how and technological innovation) the EU will get rich thanks to an army of trained sports masseurs or diet advisors, is illusory. Moreover, not only did the EU invest billions of euros in the fight against global warming, it also tied a large part of its political prestige to it. If it turns out that this was – for various reasons – a wrong decision, its political image will suffer worldwide.

As is evident from the preceding text, looking for an answer to the question at the beginning of this chapter is not clear-cut. In its history, the EU has overcome a whole series of crises that most contemporaries have no idea about. The European integration project has demonstrated several times a huge inner potential enabling it to survive beyond periods of trends towards disintegration. A realistic view of the current situation tells us that through joint efforts the Eurozone crisis too has very probably been overcome. The question remains, however, whether the EU has emerged from this crisis weakened or strengthened. It will be interesting to see whether internal contradictions among Member States will predominate in future or whether Member States will realise that the only chance in an increasingly globalizing world is to keep the EU united and act as a politically and economically strong region with ambitions to world hegemony.

The basic building block for future direction is the assumption that what the EU needs most in this chaotic and tightly-interconnected world is risk management. In other words, the Union – and its institutions – must in the first place cope with external and internal shocks, or at least learn to moderate their impact. This is closely related to the Union's ability to reinforce its power position on the global stage, be it through agreements and treaties (for example, rules on trade and capital flows) or through *ad hoc* actions enabling it to prevent future shocks or eliminate them before they destabilize the whole of Europe (this applies, for example, to armed conflicts).

The by-product of the transition from a unipolar to a multipolar system has been the erosion of the competencies and importance of global institutions. This will diminish the efficiency of global agreements and treaties in future, that is, if it is possible to conclude them at all. This will lead to the growing significance of *ad hoc* actions aimed at the most pressing problems concerning the whole planet. As was indicated by the Copenhagen Climate Change Conference in 2009, in such situations it will be the most powerful actors, i.e. the US and China, who will try to find a compromise based on their own needs and the limitations of their counterparties. If the EU does not wish to be left on the doorstep again, and wants to transform the G2 into the G3, it must find a common voice. You are either at the table or on the menu.

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The European Parliament and the European Council: Functions and Roles in the Eurozone Crisis Management. A Political Agenda Analysis

Elisa Cencig, Laura Sabani

1. Introduction

The economic and financial crisis has had profound consequences not only for the economies of EU Member States, some of which are still far from complete recovery, but also for the architecture of the Economic and Monetary Union. This work aims to analyse the action of the European Council and the European Parliament in response to the economic and financial crisis, and it purports to do so by looking at the agendas of these two institutions.

The theoretical approach underpinning this analysis is the policy agendas project, which dates back to Baumgartner and Jones' (1993) seminal work on the US political system and was later applied in comparative politics to analyse other countries (Baumgartner *et al.* 2009). In particular, the codebook developed by these scholars allows studying the actions of different institutions by applying a standardized content-coding procedure; it hence enables comparison over time and across policy fields. The agenda setting approach was therefore chosen as it provides an objective way to evaluate the policy areas the European Council (EUCO) and the European Parliament (EP) dedicated most of their attention to, as well as the specific issues in the area of economic and financial affairs.

The policy agendas project is a very flexible tool to quantitatively illustrate where the main priorities of an institution lie and how they evolve over time. In this perspective, we study the content of the EP plenary meetings agendas, which are an objective record of what the EP is up to at the macro-level, in comparison with the European Council Conclusions. Our quantitative analysis is based on the European Council Conclusions database, directly derived from the pre-existent dataset compiled by the EU Policy Agendas team, with the addition of 2013 and 2014 meetings. The European Parliament Plenary Agendas database is entirely original and was compiled

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following the same content coding procedure used for the European Council Conclusions by the scholars working on EU Policy Agendas.

Our main expectation is that the European Council, as a key deal-breaker taking highly strategic decisions, devoted a large share of its attention to the crisis, yet with a more unstable coverage pattern and a disrupted distribution of attention shares. On the contrary, we expect the European Parliament to have dedicated a limited part of its agenda space to economic and financial affairs, essentially because of the necessity to continue with 'business as usual' policies and the lower degree of mediatization of its meetings. Therefore, we expect its agenda to be remarkably more stable, with the attention devoted to economic and financial issues holding more or less a constant share.

The quantitative analysis confirms the expectations and shows that EUCO exercised a key agenda-setting function in leading the reform of the Economic and Monetary Union architecture, by devoting a consistent part of its meetings to the crisis. On the other hand, the European Parliament has been a pivotal actor in ensuring the adoption of all 'crisis-related' legislation, but it would be probably far-fetched to say that it acted as an agenda-setter, given the limited agenda share dedicated to these issues. Briefly, it might well be possible to conclude that the economic and financial crisis reinforced the role of the European Council and contributed to its image as a powerful engine of European integration. However, the implicit assumption that directly relates attention shares to the agenda-setting power of an institution is open to criticism.

The chapter is organized as follows. Section 2 briefly summarizes the main institutional features of the European Parliament and European Council and discusses the role played respectively during the Eurozone crisis. Section 3 reviews the literature on the Policy Agenda Project. Section 4 analyses and compares the policy agendas of the European Council and the European Parliament from 2009 to spring 2014. Section 5 compares the response of the two institutions to the economic and financial crisis. Section 6 concludes.

2. The European Parliament and the European Council: institutional features

2.1 The European Parliament

Directly elected since 1979 by universal suffrage, the European Parliament represents the citizens of the European Union and has traditionally acted as one of the most 'integrationist' institutions of the EU, constantly supporting the reinforcement of its supranational features, as opposed to intergovernmental dynamics which dominate the work of the Council of the EU (Hix, Høyland 2011).

Unlike most national parliaments at Member State level, the EP does not enjoy the power of legislative initiative, which in the EU is a prerogative of the Commission. It is however a co-legislator together with the Council (comprising all Member States' ministers, with a composition varying according to the policy debated) and is responsible for approving all EU secondary law, taking the forms of directives and regulations. Under the ordinary legislative procedure (OLP), known before the Lisbon Treaty as the 'codecision' procedure, it stands on an equal basis with the Council and submits all legislation proposals to a single reading; a conciliation committee is convened should any disagreement between the two legislators arise. Special legislative procedures apply in particular domains, notably the consultation procedure and the consent procedure, but the OLP has become the standard one, directly signalling the reinforcement of the EP within the EU governance structure. Analogously to legislation, the EP also has equal powers to the Council on the adoption of the EU annual budget.

In addition to its legislative and budgetary powers, the European Parliament exercises supervisory functions, namely it oversights the work of the Commission, which is requested to submit regular reports on its executive powers and on the implementation of the EU budget, as well as to reply to the oral and written questions addressed by Members of the European Parliament (MEPs). Over time, the EP has gained a strong voice in the appointment process of the European Commission, which it now has the right to approve and dismiss. Although the European Council is still responsible for choosing a candidate for the post of Commission President, under the Lisbon Treaty it is requested to take into account the results of the European elections before the candidate is finally elected by the EP. The Parliament can censure and ultimately dismiss the Commission, and enjoys a range of oversight powers over the other EU institutions.

2.2 The European Council

The European Council has completely different features, starting from its much shorter history, as it was formally created at the 1974 Fontainebleau summit. It is composed by the Heads of State and Government of all EU Member States, plus the President of the European Commission and its own President. The latter is a permanent position (elected for two and a half years) since the adoption of the Lisbon Treaty, which marked the formal recognition of the European Council as an EU institution.

Meeting at least four times a year, the main role of the European Council is to provide the Union with impetus for its development and delineate its main future priorities (Schoutheete 2006). Initially meant primarily as an arbiter trying to solve by consensus complex, sensitive political issues, its function is nowadays that of an agenda-setting body (Alexandrova *et al.* 2014a): formally deprived of any legislative powers, it can deal with any policy area and sometimes reform it quite substantially as a result of one of its summits. It addresses deadlocks in the legislative procedures, redefines the Union's priorities and gives impetus to determined issues, hence engaging in dramatic, highly mediatized issue portrayal rather than dealing with low-key, everyday matters (Werts 2008; Puetter 2014). Although the total number of meetings per year can exceed the minimum of four and is set by the European Council itself, the scope of the debate is much more limited than that of the Parliament, and each meeting inevitably has to prioritize some issues over others.

2.3 The role of the two institutions in the Eurozone crisis management and reform

As for the role played by the two institutions in the Eurozone crisis management, the action of the European Council as a major decision-maker is what first comes to mind to scholars and common citizens alike. Decisions somehow related to the economic and financial crisis were devoted ample space in newspaper headlines and appear to have been one of the most visible outputs of the European Council's action over the last years (Puetter 2012).

Major changes to the governance structure of the EU in the economic domain, as well as leaps forward in the area of financial regulation, have directly followed from intergovernmental decisions. In spite of the power of legislative initiative firmly resting in the hands of the Commission, a key agenda-setting function has been exercised by EU Heads of State and Government in order to guide the EU's action in these fields. The launch of the European Semester, the new (stricter) fiscal rules enshrined in the Fiscal Compact, the establishment of the Single Supervisory Mechanism and the European System of Financial Supervision: none of the above would have been agreed upon without ex-ante consensus within this highly politicized forum, let alone all decisions related to emergency financial assistance packages via the European Financial Stability Facility (EFSF), European Financial Stability Mechanism (EFSM) and later European Stability Mechanism (ESM) funds.

On the other hand, the European Parliament has been a pivotal actor in ensuring the adoption of all 'crisis-related' legislation, notably a wide range of regulations and directives concretizing the enacted measures, but it would be probably bold to say that it acted as an agenda-setter in this field. Although it did apply some modifications to the European Commission's original proposals, the EP appears to have stood in the half-light compared to the European Council, which has been widely acknowledged as *the* crisis-solver. Furthermore, the EP certainly has limited powers to enhance the share of its agenda dedicated to economic and financial affairs: even if MEPs can discuss own initiative reports or motions for resolution, most of the assembly's work – at least in the legislative domain – consists in taking forward the various committees' activities, in turn influenced by the Commission's proposals.

This perceived inequality in the relations between the two institutions, whereby the European Council acts as a veritable deal-breaker, while the

European Parliament tends to ratify already settled decisions, may reflect a change in the institutional balance of the Union. It might be possible that the economic and financial crisis reinforced the prerogatives of the European Council and contributed to its image as a powerful engine of European integration, while the EP has not been granted a substantial increase in power, nor has it gained a major role in the newly reformed system of economic policy coordination. On the other hand, this perception might only be due to the different degree of mediatization of the two institutions. The European Council, although relying upon a considerable influence, does not exert any legislative power whatsoever and is compelled to rely on the Commission and the co-legislator to implement its strategies and transform its *desiderata* into outcomes, hence making the EP a key decision-maker whose voice simply cannot be ignored.

3. The Policy Agendas Project: review of the literature

The Policy Agendas Project was launched in the United States by Frank R. Baumgartner and Bryan D. Jones, who focused in their research on the allocation of political attention at the beginning of the policy cycle (Baumgartner, Jones 1993; 2005). The theory is evoked here only in its essential features, as the literature comprised in the policy agendas project, both on the US system and compared, is vast and would require an entire chapter for an adequate presentation. Baumgartner and Jones's analysis, aiming at complementing established studies of the public policy process with a more nuanced view of its initial phases, largely drew inspiration from the psychological concept of bounded human rationality. Human beings do not always make the best decisions in complex environments and do not always attend to the most pressing problems, as dynamics of attention shifting prevent individuals to devote their consideration to the full range of issues at stake. The central assumption of the theory is that these attention dynamics characterize individuals and institutions alike, hence government officials and governmental institutions present similar cognitive boundaries. Government decision makers often have huge amounts of information thrown at them, especially when they are surrounded by actors pushing for policy change: they are faced with fiercely competing issues and it is very difficult to assess what bits of information are relevant or accurate, which ones deserve more attention than others. The political system is accordingly seen as an attention allocating instrument, with a huge amount of information on the input side and public policies as an output. The process according to which information is prioritized, and attention is allocated to some problems rather than others, is called agenda setting, and enables the reduction of redundant incoming information streams. The scholars assume that information is not used efficiently in politics, as some bits are totally ignored while others are given disproportionate attention and credibility, giving rise to a punctuated pattern; this process is inevitable and inherently linked to the aforementioned shortcomings of human cognition (Baumgartner, Jones 2005).

Baumgartner and Jones's research analyses the process whereby the US political system processes information by detecting signals and prioritizes them basing on urgency and other criteria. The preliminary stage of decision making, where attention is allocated to one issue over another, is a very sensitive stage when thresholds of importance based on perceived urgency determine priority setting decisions. Their theory of governmental attention allows them to put forward a generalized model of punctuated equilibrium in public policy (Baumgartner *et al.* 2007). The bounded rationality in information-processing results in the neglect of information until it can no longer be ignored: at the tipping point, it becomes disproportionate and a major shift in attention follows. For this reason, political change is not incremental but rather characterized by an alternation between under-reaction (reflecting stability) and over-reaction (the punctuations). Empirical studies have confirmed the punctuated equilibrium model, which predicts the distribution of attention change to display a high level of skewness, with a majority of very small attention shifts coupled with a considerably high number of large ones, while medium-sized changes are relatively less frequent (Baumgartner *et al.* 1998).

Regarding its methodology, the policy agendas project produced a dataset tracking policy change in the US since the Second World War, with the help of specific policy content categories. The key assumption behind the use of this database is that attention to an issue can be meaningfully measured by its relative occurrence in policy documents, with the number of references interpreted as an indicator of the issue's status on the political agenda (Alexandrova *et al.* 2014b). The analyzed resources include among others congressional hearings, public laws, executive orders, Gallup surveys, US budget authority data, with each item content-coded according to a comprehensive list of 19 topics and 225 subtopics.

All observations are coded in accordance with the single predominant policy area and are assigned a numerical value, with the resulting relative frequency of one issue signalling its rank on the overall agenda. The resulting database is a powerful tool for quantitative and objective comparison across years and issue areas, in contrast with the qualitative, case-study approach that is predominant in the public policy literature. This approach has remarkable advantages over alternative strategies of data collection such as interviews and surveys, primarily in view of the fact that its standardized nature allows for comparison not only over time, but also between different institutions within a political system or across political systems altogether.

The Policy Agendas Project has been successfully exported from the United States with the creation of the Comparative Agendas Project (CAP) and the EU Agendas Project, resulting in a wealth of non-US based studies enriching the literature (see e.g. Baumgartner *et al.* 2006; Green-Pedersen, Walgrave 2014). Over the past decade, there has been an increased scholarly attention to agenda setting processes in the European Union (Princen 2009, 2011). Alongside being an essential stage of the policy process in any political system, the relevance of studying agenda setting in the EU has distinctive features. Studying the EU agenda may in fact highlight some patterns of its institutional and political set-up, which are all the more interesting because of the flexibility and continuous adaptation of the EU's structure over time. In addition, the boundaries of agenda span with its expansion and contraction dynamics might represent a promising source of information on the process of EU integration, notably by analyzing which (and how) issues are dealt with at the European in relation to the national level (Alexandrova *et al.* 2014b). Nevertheless, a majority of existing studies tends to adopt a case-study approach, hence failing to reap the benefits of the large quantitative datasets that are central to the policy agendas perspective (Princen 2013).

The European Council has been the object of particular attention by the EU Policy Agendas team. Researchers collected empirical data by content coding all European Council Conclusions (previously called 'Conclusions of the Presidency') starting from the establishment of this institution in 1975, in order to determine what issues have been addressed at different summits and analyse attention dynamics over the years and phases of European integration. Because of the secretive, closed-door nature of its deliberations, the Conclusions mirror only approximately the debates held at meetings, but they represent the only available source of information. The EU codebook, comprising 21 major topics and some 250 subtopics, has been used to code European Council Conclusions at their smallest unit of analysis, the (quasi) sentence level (Alexandrova *et al.* 2014b). The data allowed scholars to analyse patterns of agenda development within the EU leaders' forum.

Two main findings appear relevant in relation to the European Council's agenda. First of all, some topics related to the 'core functions' of government, i.e. international affairs, economic issues and governance of the EU, take up a large part of the agenda most of the time, a result similarly found by comparative analyses of executive agendas in a number of countries. Taken together, the three topics attracted almost half of the agenda space of the European Council over the entire analysed 1975-2010 period, while the remaining policy fields were devoted each between less than 1 and 7 percent of the total attention (Alexandrova *et al.* 2012a). In spite of the distinctive pattern of competences attribution between the EU and Member State levels, the European Union hence shows a common bias towards general core government issues as addressed by all political systems (Alexandrova *et al.* 2012b). A second key finding of their analysis is the empirical validation of the punctuated equilibrium theory of policy-making, according to which small, incremental changes are punctuated by large shifts in attention to problems (Alexandrova *et al.* 2012a).

4. Policy agendas of the European Parliament and European Council from 2009 to 2014: a comparison

In this section we analyse and compare the policy agendas of the European Council and the European Parliament over the period from autumn 2009 to spring 2014, corresponding to the EP's 7th term. Since our aim is to describe the reaction of the EU institutions to the economic and financial crisis, the study does not go further back in time. This choice prevents the possibility of comparing the pre- and post-crisis scenario, but seemed more suitable to our objectives and constraints. Year 2009 is taken as a good approximation for the start of the crisis, although some of its effects had already begun to appear in 2008, in order to limit our analysis to one parliamentary term and allow for a meaningful assessment of the last legislature.

Given the 'small agenda' of the European Council and the highly mediatized nature of some crisis-related measures (to name some examples, the several decisions to grant financial assistance to Greece or the resolution to establish a banking union), we expect the European Council to give much more space to issues related to economic and monetary affairs, as well as the financial crisis, compared to the Parliament. The latter is expected indeed to devote a relatively limited coverage to economic and financial affairs in its political agenda, yet this attention is expected to be more stable over time. In fact, it is not uncommon that European Council meetings focus solely on a constrained number of issues at time, issues that may receive very in-depth handling but might similarly be dropped off the agenda at the following meeting, when a new 'hot topic' emerges or policy priorities shift. The European Parliament instead has to continue with 'business as usual', i.e. legislation and implementation related to all existing policies, which may not be revolutionized but need 'daily care' and cannot be simply overlooked. Therefore the attention devoted to all policy areas (not only economic or financial issues) is expected to follow a more constant pattern over time, with small and medium-size changes in attention but less major disruptions than what is expected for EUCO. When looking at the qualitative content of the agendas, it is also highly likely that the two institutions prioritize different policy areas, not only at the macro-level but also at the micro-level when analysing the most debated items under the economic and financial umbrella.

The European Council Conclusions database is directly derived from the pre-existent EU Policy Agendas dataset, with the addition of 2013 and 2014 meetings (up to the one taking place on 20-21 March 2014). Only the data from the June 2009 summit onwards were retained, and the database was extended using the same content-coding procedure, in accordance with the EU Policy Agendas Codebook. Each item (sentence or quasi-sentence) is assigned two main variables (alongside date and year), which are 'CAPIC' and 'main CAPIC'. CAPIC (Comparative Agendas Project Issue Code) is the main variable and is meant to code for the policy content of each single unit of analysis. Each unit is assigned only one of the topic codes, which are organized in major topics (main CAPIC – e.g. major topic 1 is for Macroeconomics, 2 for Civil Rights, Minority Issues and Civil Liberties, 3 for Health and so on) and subtopics (CAPIC – e.g. within the major topic 'Macroeconomics' 101 refers to Inflation, Prices and Interest Rates, 103 to Unemployment Rate, 105 to Budget and Debt).

In total, the 2009-2014 dataset comprises 31 meetings: 5 of them took place in 2009 (June, September, October, November and December), 6 in 2010 (February, March, June, September, October and December), 7 in 2011 (February, June, December and two each in March and October), 6 in 2012 (January, March, June, October, November and December), 6 in 2013 (February, March, May, June, October and December) and one in 2014 (March). In addition to the March, June, October and December sessions which are the four yearly meetings foreseen by the Lisbon Treaty, some of these were informal (September and November 2009, February 2010, 26 October 2011, January 2012), others were euro area summits (26 March 2010, 11 March, 21 July and October 2011, January 2012) and some were of a special or extraordinary nature (11 March 2011 and November 2012). The database includes 6690 coded sentences or quasi-sentences.

The European Parliament plenary agendas database is entirely original, but similarly compiled following the same content coding procedure. There were 73 plenary sessions of the EP during the 7th term, the first one taking place on 14-17 September 2009 and the last on 14-17 April 2014, with elections taking place for the renewal of the assembly in May 2014. Their distribution over the years is the following: 6 were held in 2009, 17 in 2010 and 2011, 15 in 2012, 12 in 2013 and 6 in 2014. Every item on each plenary agenda is coded, be it a vote on a legislative proposal, an own initiative report discussed by the EP or a debate on any policy area: for example, when the agenda item is *State aid rules on services of general economic interest – Report* it is assigned CAPIC 1541 (competition policy) and main CAPIC 15 (banking, finance and internal trade). The database contains a total of 5127 agenda items, with an average of 70 agenda items per session.

4.1 The agenda of the European Parliament (2009-2014)

4.1.1 Composition and dynamics of the EP plenary agenda

The allocation of attention across policy topics shown in Table 1 underlines a clear pattern of emphasis on certain fields. In conditions of scarce agenda space, issues do have to compete for attention and their relative frequency can be taken as a measure of saliency. Research on domestic policy agendas in a comparative perspective has demonstrated that there is a number of more or less unvaried core topics, namely economic affairs, government structure, defence and international affairs, consistently ranking at the top

(Alexandrova *et al.* 2014a). In the case of the European Parliament's plenary agendas, we can indeed observe that government issues and foreign affairs occupy respectively the first and second position in terms of agenda space. Banking and finance, together with internal market issues, are also high on the EP agenda; this result falls in line with the priority constantly given to the creation and functioning of the single market over the different waves of European integration.

Table 1 – Aggregated attention to policy fields in the EP, 2009-2014.

Policy field	Frequency	Percentage
EU Governance and Government Operations	1438	28.05%
International Affairs and Foreign Aid	865	16.87%
Banking, Finance and Internal Trade	462	9.01%
Agriculture and Fisheries	275	5.36%
Foreign Trade	237	4.62%
Macroeconomics	228	4.45%
Transportation	214	4.17%
Environment	192	3.74%
Civil Rights, Minority Issues and Civil Liberties	189	3.69%
Law and Crime	167	3.26%
Immigration	165	3.22%
Remaining 10 policy fields (less than 3% each)	695	13.56%
All	*5127*	*100.00%*

The rest of the policy areas are all given less than 5% of the agenda each, with relatively more attention to agriculture and foreign trade, while the lowest ranks are occupied by public land and territorial issues, media/culture and education. The attention to all topics on the agenda (on a semester basis) is displayed in the boxplots of Figure 1, which clearly shows how most salient issues are also those subject to the higher degree of variation in their relative frequency on the agenda.

For example, governance occupies the first place on the EP agenda, but its relative frequency varies widely, ranging from 20% to 36%; a similar pattern can be easily detected for international affairs (with a minimum of ca. 12% and a maximum of 21% of agenda space) as well as banking/financial issues and foreign trade. On the contrary, policy areas consistently receiving a very low degree of attention have a much more stable pattern, with no relevant changes in their relative frequency on a semester basis, as it emerges from the graph. The only possible exception is agriculture, which has a mean of ca. 5% of the agenda space but a maximum value of 10%. The variation for all other low-ranking items instead occurs within a concentrated range, meaning that the EP coverage has a very constant nature. This finding matches well with the nature of this institution, which deals with all policy areas taken up by the EU, mainly exerting a legislative function and hence debating/approving pieces of legislation (be it directives or regulations) across the whole spectrum of policy topics.

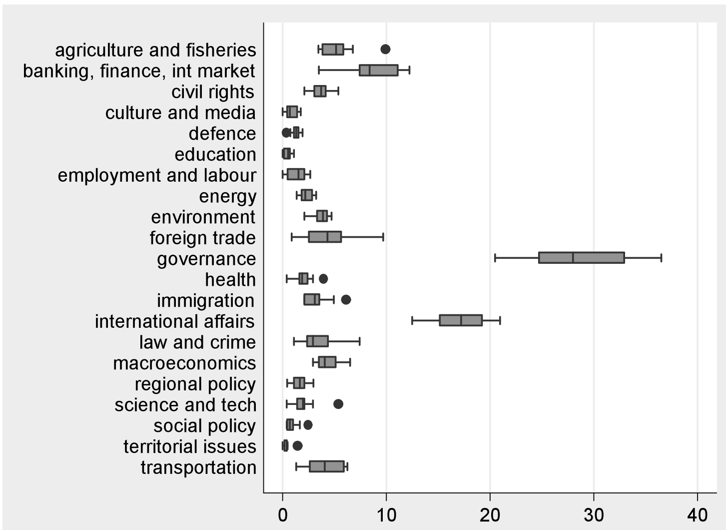

Figure 1 – EP attention to all topics on the agenda per semester within the period 2009-2014.

EU governance and government operations cover almost 30% of the whole agenda of the EP plenary sessions, surpassing largely any other agenda item over the whole 5-year period under analysis. Under this main policy area, almost a half of the occurrences are general matters linked to government, the future of the EU or budgetary matters (all operations related to the budget, from its approval to the discharge procedure and sectorial allocations, are indeed coded in this category). Frequent matters of debate are also institutions and inter-institutional relationships (11%), while nominations/appointments and regulation of political life and ethics both take up more than 5% of the agenda space under the governance umbrella. The second largest topic on the European Parliament agenda is international affairs, with almost 17% of the agenda space, reflecting inter alia the ever-growing powers the EP has gained in this policy field over time. Once again, general references are most frequent (35% of the total), but almost 30% of all foreign affairs-related agenda items is represented by human rights, signaling the traditionally intense Parliament's concern for human rights issues and the strong role it plays in this field. Other relevant subtopics are foreign aid and

EU enlargement, with each about 10% of the space. Banking, finance and internal trade comes third on the EP agenda, with 9% of the whole agenda space: the European Parliament is hence more concerned with single market and banking/financial issues than with macroeconomics, which occupy the 6th place barely covering 4.45% of the agenda. The variety of issues under this policy area is very wide, with five different topics getting about 10% of the total occurrences: financial markets regulation (hardly surprising, given the high priority given to this policy field during this last term), harmonization of technical requirements, banking system and financial institution regulation, creation of the common market and consumer protection.

Taken together, the three topics of EU governance, international affairs and financial/single market issues attracted more than half of the attention of the European Parliament over the whole 7th term. On a semester basis, their cumulative frequency varies between 45% and 60%, while the remaining 18 policy areas are given a much more limited attention share, as shown in Figure 2. These results therefore confirm the findings of comparative research, showing that 'core functions' of government together account for the lion's share in a political institution's agenda, of course with slight differences in the relative saliency among the exact top areas. However, an interesting pattern can be observed if one adopts a different unit of analysis, notably by breaking down the data and analyzing the distribution of attention by session, instead of taking semesters as units of comparison.

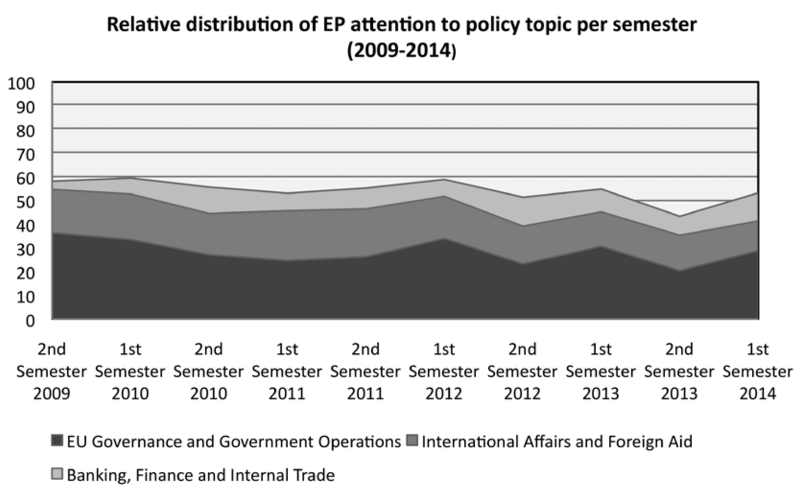

Figure 2 – Relative distribution of EP attention to core topics per semester, 2009-2014.

Figure 3 presents the same statistic, i.e. the cumulated frequency of the three top issues, but looking at each plenary session held by the European Parliament. Interestingly, a far wider degree of variation emerges; there are in fact single sessions where these three core topics – EU governance, international affairs and banking/finance – together cover less than 40% of the plenary agenda, while in other sessions (e.g. October 2010, May 2012 or April 2013) they easily reach an astonishing 80% of total agenda space.

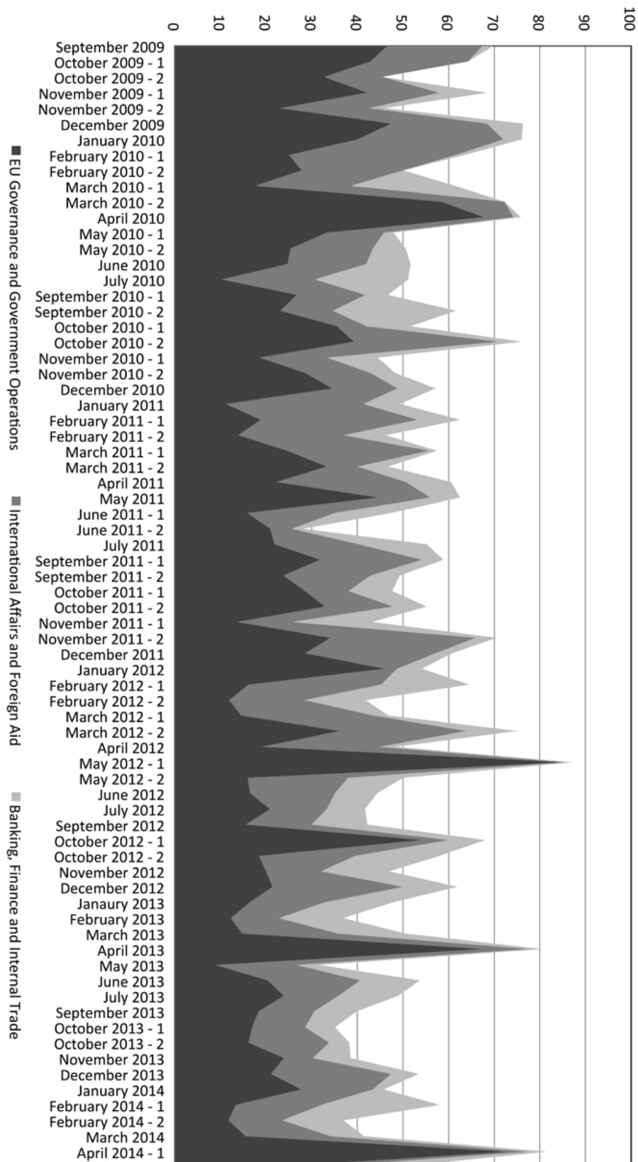

Figure 3 – Relative distribution of EP attention to core topics per session, 2009-2014.

4.1.2 Attention to economic issues in the European Parliament

In order to better enlighten how the European Parliament reacted to the economic and financial crisis starting from 2009 (the year of its 7th direct election by European citizens), we will now take a closer look at its specific attention to the policy area related to macroeconomics, as well as the subtopics under this category. As we have already seen, a preliminary observation is that 'economic issues' is not part of the top-ranking three policy areas consistently highest on the EP agenda. As Figure 4 shows, its relative frequency on a semester basis varies between less than 3% and slightly above 6%, hence never enjoying a clear-cut priority on plenary agendas. Nevertheless, a session-on-session analysis again highlights a far wider variation, with occasions when macroeconomic issues alone covered almost 30% of the agenda (Figure 5); in 8 sessions out of 73 macroeconomics exceeded 10% of relative frequency and it is even possible to notice than during 13 of its sessions the EP did not deal with this policy area at all.

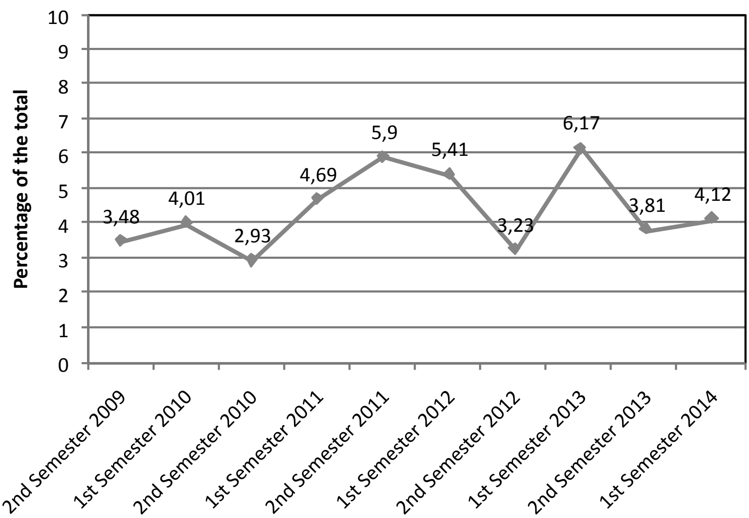

Figure 4 – Relative frequency of macroeconomic issues on the EP agenda per semester, 2009-2014.

After acknowledging that the attention of the EP to economic issues, in terms of agenda space, has not been particularly high during the 7th term, we now assess which of the specific issues under this wide umbrella were mostly tackled by the European Parliament. On average during the 2009-2014 period, general macroeconomic issues were given the highest attention with over 40% of economy-related agenda space, but other important areas have been taxation and monetary issues (including the role of the ECB), as Table 2 illustrates.

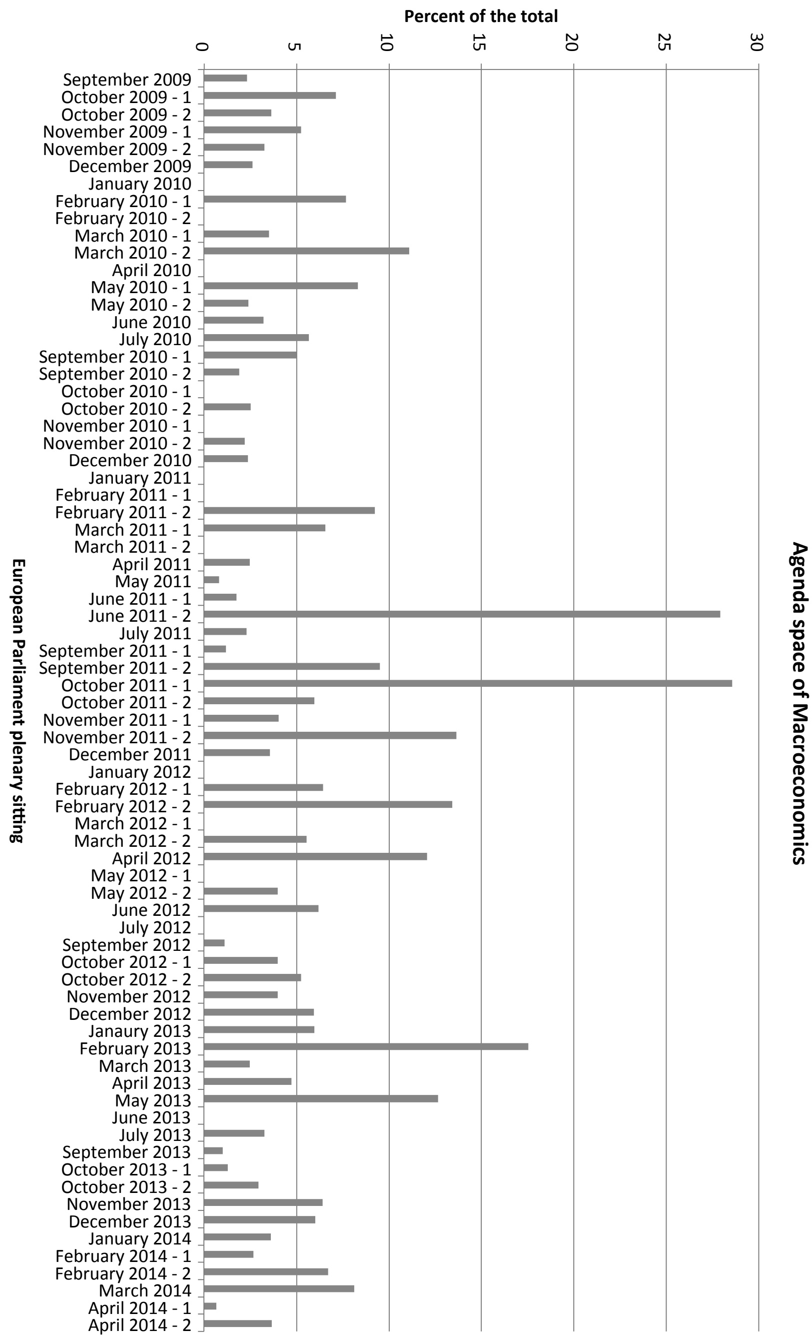

Figure 5 – Relative frequency of macroeconomic issues on the EP agenda per session, 2009-2014.

Table 2 – Attention to economic issues at the subtopic level in the EP, 2009-2014.

Subtopics in the Macroeconomics policy field	Percentage
General Macroeconomic Issues	41.67%
Taxation, Tax Policy, and Tax Reform	16.67%
Monetary Issues and the ECB	14.91%
Budget and Debt	10.09%
Industrial Policy	7.89%
VAT	6.58%
Remaining Macroeconomic Issues	*2.19%*

As usual, taking a closer look at the different semesters permits to interpret the changes in attention to the single particular topics (Figure 6). Although changes are very limited on an absolute scale – they all occurred within less than 6% of the total agenda – we can see that not all issues were covered by the European Parliament each semester. For example, taxation was not present on the EP plenary agendas for an entire year, between mid-2010 and mid-2011, while general issues consistently built up the bulk of the agenda space devoted to economic affairs. VAT issues were similarly not dealt with in 3 out of 10 semesters, as was the case for industrial policy issues, present only in seven instances. Of course a session-based analysis would reveal even more interesting details, but we thought it dispersive to repeat this kind of breakdown for each of the 73 plenary sessions under examination.

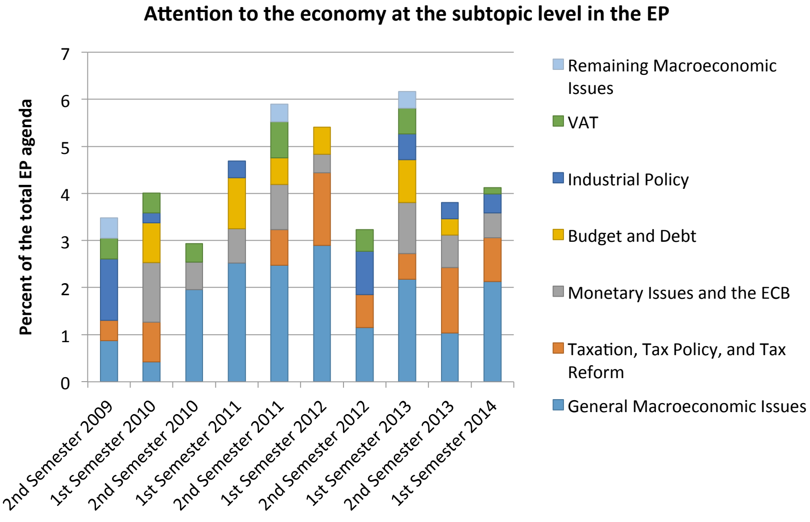

Figure 6 – Attention to the economy at the subtopic level in the EP, 2009-2014.

4.2 The agenda of the European Council (2009-2014)

4.2.1 Composition and dynamics of EUCO Conclusions

Our analysis of European Council Conclusions over the period 2009-2014 confirms the results of scholarly research, which has found a limited number of core topics of government to account for about half of EUCO's agenda. In particular, Alexandrova *et al.* (2012a, 2014a) found that the three policy areas of international affairs, macroeconomics and governance are consistently ranking highest among EU Heads of State and Government's concerns, at least in a pooled analysis of the whole 1975-2010 period (i.e. since the European Council was formally established, at the 1974 Fontainebleau summit). Foreign affairs have traditionally covered almost a quarter of EUCO's agenda, macroeconomics about 15% and governance/government operations around 10%. Our results for the last five years, however, highlight a partially different pattern, with substantial differences in the percentage of attention devoted to the main policy areas. Table 3 shows the allocation of attention to policy areas over the last five years, with the two top fields being macroeconomics and international affairs; banking, finance and internal trade surpassed governance and reached the third place (with double the relative frequency this policy area has over the whole 1975-2010 time span).

Table 3 – Aggregated attention to policy fields in EUCO, 2009-2014.

Policy field	Frequency	Percentage
Macroeconomics	1682	25.16%
International Affairs and Foreign Aid	1012	15.13%
Banking, Finance and Internal Trade	822	12.29%
EU Governance and Government Operations	469	7.01%
Employment	399	5.97%
Energy	332	4.96%
Defence	323	4.83%
Environment	282	4.22%
Foreign Trade	277	4.14%
Immigration	247	3.69%
Remaining 11 policy fields (less than 3% each)	843	12.61%
All	*6689*	*100.00%*

Even if no low-ranking policy area – such as for example education, health or social policy – has managed to reach the top of the agenda, we see that economic issues gained the first place in EU leaders' attention, with 25% of the total agenda space, hence an entire 10% more agenda space than in the pooled study of the last 40 years. This is hardly shocking when one considers the pivotal role played by this institution in the management of the economic and financial crisis, and the numerous deal-breaking decisions it has taken on how to reinforce the EMU's architecture, as well as on the financial assistance granted to crisis-ridden countries. On the other hand, international affairs have covered only 15% of the agenda space (compared with 24% over the whole history of EUCO), clearly indicating that foreign affairs lost their privileged position in EU leaders' Conclusions, hence representing a secondary concern over the very last years. EU governance and government operations lost the third place, but its relative frequency is not enormously lower, with 7% compared to 10% in the pooled 1975-2010 analysis. Nonetheless, it was surpassed by banking/financial issues, which is also hardly surprising as a result given the extensive efforts made at EU level to reinforce financial markets' and banking institutions' regulation. Employment-related issues also received 6% of agenda space, a degree of attention probably linked to the harsh effects of the crisis on the real economy in most Member States.

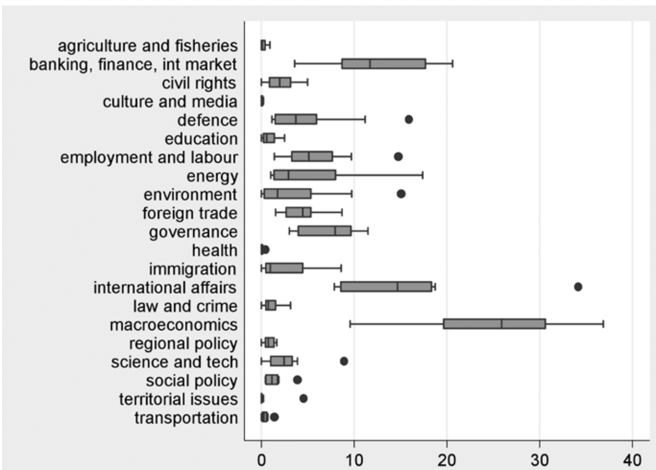

Figure 7 – EUCO Attention to all topics on the agenda per semester within the period 2009-2014.

The boxplots displaying the relative frequency of each of the 21 policy areas on a semester basis reveal interesting additional information, especially if compared to the same graph built with EP plenaries' data (Figure 1). The variation in the degree of attention devoted to each policy area is indeed much higher than in the case of the European Parliament, effectively mirroring the different nature and functions of the two institutions. The European Council Conclusions are of course a document entirely different in structure (and purpose) from EP plenary agendas, but they can be taken as a sensible proxy for its activity. The European Council, playing the role of an agenda-setter which establishes *à la fois* priorities and dimensions of the integration process, enjoys an almost unlimited flexibility in its freedom to choose which matters to deal with, while the agenda of the European Parliament has a much more structured format, in view of the institution's legislative, supervisory and budgetary powers and of its established Rules of Procedure. The areas displaying a wider degree of variation in their relative frequency are those at the top of the agenda, particularly macroeconomics which has a minimum of 10% and a maximum of almost 40% of the agenda space on a semester basis. Degrees of variation in attention of almost 20 percentage points can be similarly seen for banking, financial and single market issues as well as for the area of energy; several others policy areas (e.g. defense, employment, environment, international affairs) also display a 10 percentage points difference in their minimum/maximum agenda space on a semester basis. These findings reflect not only the institution's responsibilities and powers, but also the fact that the European Council often convenes special or informal meetings entirely devoted to specific issues.

The three core topics in EUCO Conclusions over the 2009-2014 period together account for almost half of its agenda, but some variation in their cumulative relative frequency is visible when we look at data on a semester basis (Figure 8), showing that these policy areas taken together covered a minimum of 40% (2nd semester 2009) and a maximum of almost 70% (2nd semester 2010) of total agenda space. Once again if we enlarge our study with a qualitative analysis in order to investigate the reasons behind this variation, it is easy to recall that the months from July to December 2010 were characterized by important advancements in crisis management, with e.g. the creation of a task force on economic governance and the establishment of the permanent European Stability Mechanism.

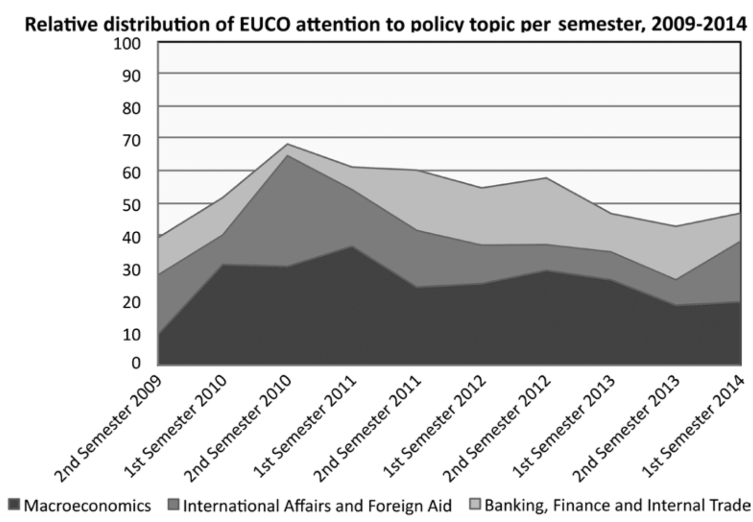

Figure 8 – Relative distribution of EUCO attention to policy topic per semester, 2009-2014.

If we proceed to breakdown the data on a meeting-per-meeting basis, we find an astonishing degree of variation in the relative proportion of macroeconomic, international affairs and banking/finance issues, underlining several instances where one of these policy areas alone accounted for 60-80% of the total agenda, as was the case for purpose-specific meetings. Looking at Figure 9, we can easily see that the February 2010 meeting was entirely devoted to economic issues; it was indeed the occasion where a first assistance loan for Greece was agreed upon. A similar pattern emerges for December 2010, the summit when the decision to establish a permanent European Stability Mechanism was taken; in November 2012 the meeting was an informal one convened to untangle the negotiations around the 2014-2020 Multiannual Financial Framework. Conversely, international affairs was the dominant topic in September 2010, dedicated to the strategic orientations of the EU's external policy, as well as during the first March 2011 meeting, which was devoted to the 'Arab Springs', i.e. the democratic transitions in the Southern Neighbourhood countries. As for banking, finance and internal trade, the only summit when this policy area was preponderant is the second one in October 2011, when EU Heads of State and Governments concentrated on euro area governance, the Greek crisis and stabilization mechanisms for the banking sector.

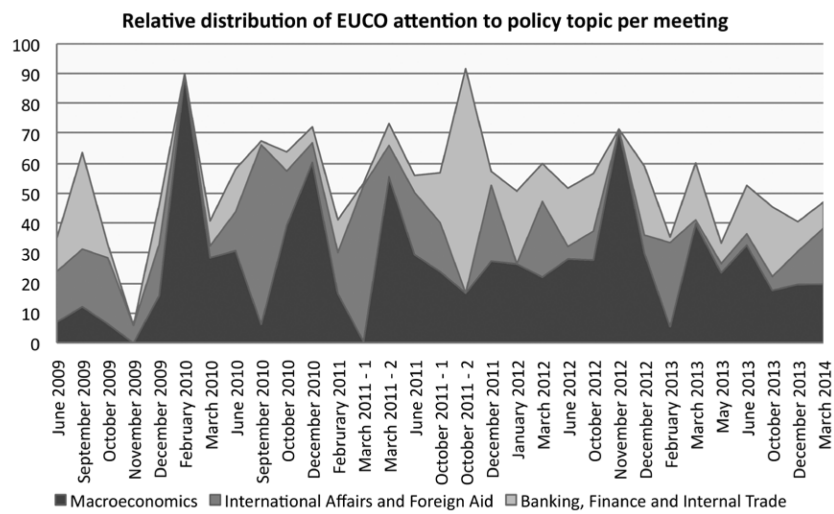

Figure 9 – Relative distribution of EUCO attention to core topics per meeting, 2009-2014.

4.2.2 Attention to economic issues in the European Council

In comparison with the European Parliament, it is apparent that the European Council devoted a consistently higher degree of attention to economic issues, covering a good quarter of its agenda space on average. When we look at data on a semester basis (Figure 10), there is some variation between the minimum coverage (less than 10% in the second semester of 2009) and the maximum one, more than 35% in the first semester of 2010. As usual, breaking down the data by meeting allows us to better identify the dynamics of attention to economic affairs in this institution: Figure 11 replicates somehow the findings of Figure 9 but concentrating on this single policy area gives us a clearer view of the enormous degree of variation in attention (and agenda space) that EU leaders devoted to economic issues, ranging from no attention at all (November 2009) to an astonishing 90% of the agenda in February 2010.

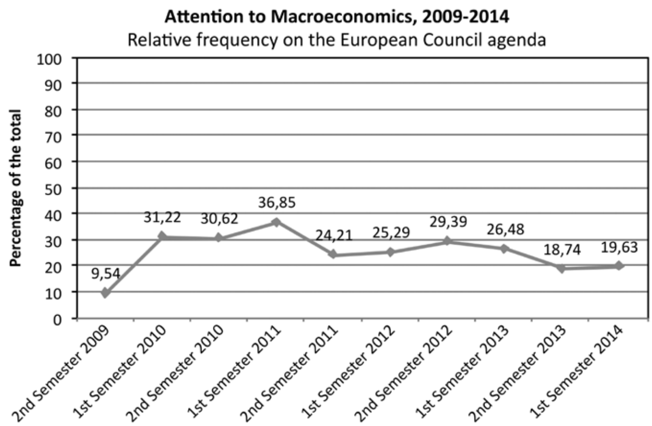

Figure 10 – Relative frequency of macroeconomic issues on EUCO agenda per semester, 2009-2014.

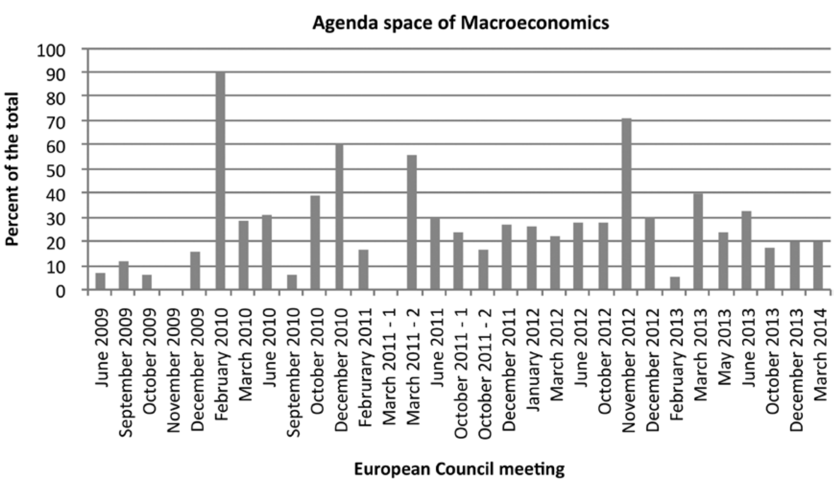

Figure 11 – Relative frequency of macroeconomic issues on EUCO agenda per session, 2009-2014.

If we look specifically at the relative saliency of single subtopics within the macroeconomics policy area for EUCO Conclusions, it is apparent that most of the times EU leaders discussed about general economic issues. Nevertheless, the agenda share taken up by budget and debt mirrors the huge concern of this intergovernmental institution about the sustainability of public finances, and the decisions taken to reinforce the Stability and Growth Pact by tightening its fiscal rules. In comparison with the European Parliament, whose agenda shows a higher focus on very well determined issues, the European Council debated the economic and financial crisis mostly in general terms. EUCO Conclusions are indeed formulated often in a very vague and elusive way, and it is not among the European Council's responsibilities to formulate precise policy initiatives.

Table 4 – Attention to economic issues at the subtopic level in EUCO, 2009-2014.

Subtopics in the Macroeconomics policy field	Percentage
General Macroeconomic Issues	71.40%
Budget and Debt	14.39%
Taxation, Tax Policy, and Tax Reform	5.23%
Industrial Policy	3.69%
Monetary Issues and the ECB	3.63%
Remaining Macroeconomic Issues	*1.67%*

Investigating the specific pattern of attention to economic affairs for each of the ten semesters in the analysed period (Figure 12), we still find that general references to the economic situation were most frequent, while most of the other topics enjoyed a rather stable, yet limited, percentage of the total agenda space. Some issues were totally neglected in some semesters, but the most interesting finding is perhaps that budget/debt issues, which covered almost 10% of the total economy-related agenda in 2010 and early 2011, almost disappeared during the last year or so, reflecting the apparent 'calm' situation after the worst phases of the sovereign debt crisis and the loss of attention to fiscal-related issues.

5. A comparison between the European Parliament and the European Council: attention to the economic and financial crisis

Aiming to compare directly the two institutions' response to the economic and financial crisis, we constructed a new variable to account for the policy subtopics specifically related to it. In order to do this, we clustered together some of the policy areas coded in the EU Policy Agendas Project codebook under the two umbrellas of macroeconomics and banking, finance and

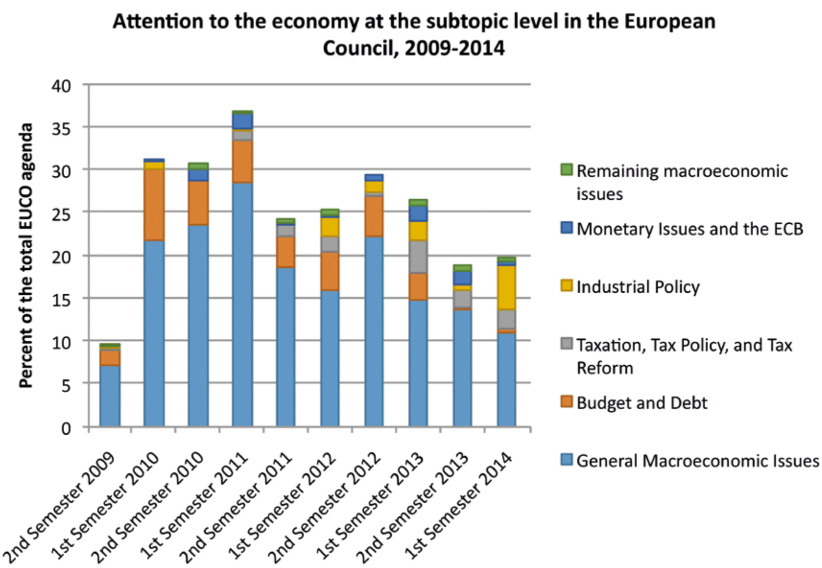

Figure 12 – Attention to the economy at the subtopic level in EUCO, 2009-2014.

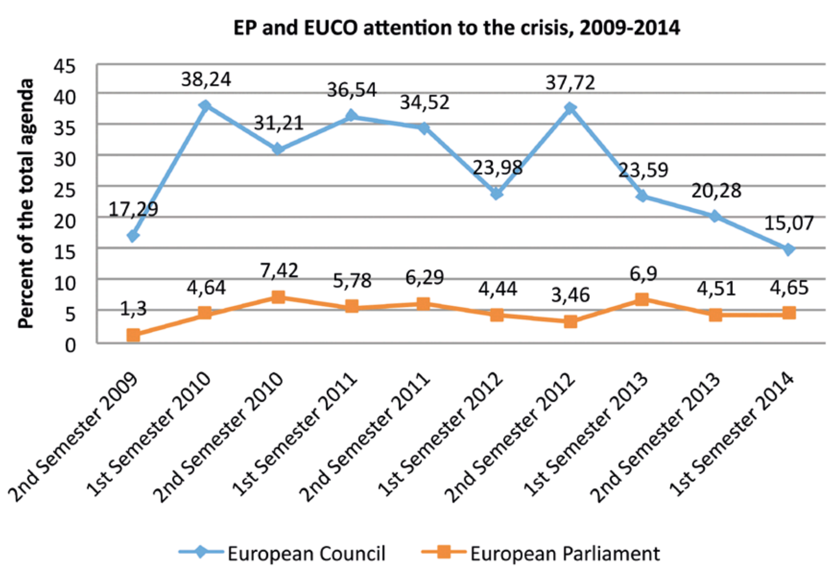

Figure 13 – EP and EUCO attention to the crisis, 2009-2014.

internal market issues. In particular, we grouped the following (and directly crisis-related) subtopics: general macroeconomic issues, unemployment rate, monetary issues and the ECB, banking system and financial institution regulation, financial market regulation.

By plotting together the relative frequency of this fictional variable, which is used as a proxy for attention to the crisis, for both institutions on a semester basis, we can still detect a considerably lower portion of agenda space devoted to these issues by the EP in comparison with the European Council, as emerged already in the previous paragraphs. EUCO's attention to the crisis indeed varied among 20% and almost 40% of the whole agenda, while the EP's attention never exceeded the 10% limit, with a much more stable pattern over time (Figure 13).

6. Conclusions

The novelty of our study lies in the comparison of the agendas of two institutions that have been central to EU-level management of the post-2008 economic and financial crisis, namely the European Council and the European Parliament. We add to the existing literature by including in the analysis the plenary agendas of the European Parliament, thereby using a new data source that was previously neglected by policy agendas scholars, who have traditionally focused on legislative output, interrogations or budget outlays to study the activities of parliamentary institutions.

Our quantitative analysis shows that the European Council devoted large part of its agenda to solving the economic and financial crisis by extensively dealing with the related problems as well as the measures to take, while the European Parliament only dedicated a very limited part of its agenda to crisis-related issues and measures.

It might well be possible that the economic and financial crisis reinforced the role of the European Council and contributed to its image as a powerful engine of European integration, while the EP has not been granted a substantial increase in power, nor has it gained a major role in the newly reformed system of economic policy coordination. However, these results could be also explained referring to the different structure of the documents under analysis, and the almost unrestrained flexibility of European Council Conclusions in relation to the highly fixed structure of European Parliament agenda[1]. The draft agenda of each plenary session is in fact drawn up by the Conference of Presidents of the political groups, taking in consideration both the recommendations of the Conference of Committee Chairs and the Commission's

[1] Concerning the latter, a 7 percent range of attention change (minimum-maximum) is in fact far from negligible when one takes into account the institutional hurdles political actors (be it parties or single MEPs) face in order to change or influence the agenda of plenary sessions.

work programme[2]. The policy and legislative calendars of the committees' work and of the European Commission are the main basis for building the European Parliament's agenda, which is directly linked to the activities of its specialized subunits as well as to the Commissioners' initiatives[3]. Therefore, individual MEPs have little influence on the construction of the agenda of the European Parliament. Furthermore, the EP has a limited ability to react to urgent matters: the main instrument the EP has to respond to major current events is the opening speech of the Parliament's President, which allows him to address the latest developments on any major issue, often calling the Commission to act (and submit policy proposals) in a given area.

In conclusion, it is worth noting that the policy agendas methodology was adopted for its usefulness in assessing attention patterns and dynamics, yet it fails to capture features of a qualitative nature such as the different powers of the institutions. Hence, this approach of course needs to be complemented by additional viewpoints in order to account for the fundamental role held by the EP in crisis management and EMU reform, particularly in view of the key legislative measures which it adopted as a co-legislator and which contributed to reinforcing the economic governance and financial regulation architecture of the European Union. Future research may also enlarge the scope of agenda and attention dynamics studies to the other institutions of the EU, notably the European Commission, in order to draw an encompassing picture of the EU political system.

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[2] Rule 137, Rules of Procedure of the European Parliament.

[3] The rigidity of the plenary agenda derives from the high institutional hurdles inherent in its modification: according to Rule 140, amendments on the final draft agenda may be proposed by a committee, a political group or a group of at least 40 MEPs and must be voted in plenary.

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PART IV

Towards the Creation of a New Global Currency and World Finance

Banking on the Euro as an International Currency: Consequences for East-Asian Currencies

Bernadette Andreosso-O'Callaghan

1. Introduction

In the eyes of some commentators, the 1997 Asian Financial Crisis (AFC) was signaling the end of the 'Asian model' and, in particular, the end of the Asian firm with the severe restructuring of the *chaebol* in South Korea and the dissolution of the Japanese *keiretsu*[1]. For EU member countries, the AFC represented an unexpected opportunity for the nascent euro to carve itself a niche in global finance, facilitating thereby the internationalization of the new European common currency. As it turned out, and as has been argued elsewhere (Andreosso-O'Callaghan, Zolin 2010), the AFC represented in fact an opportunity also for East-Asian countries. The Japanese proposal for an Asian Monetary Fund and the ensuing Chiang Mai Initiative signaled a first distancing of East-Asian monetary authorities from the Bretton Woods institutions and from the US dollar-centered monetary and financial global system.

This distancing was given an impetus with the 2008 Global Financial Crisis (GFC). For East-Asian monetary authorities, the GFC enhanced the widespread suspicion and mistrust *vis-à-vis* the Western-based global financial institutions as well as *vis-à-vis* both the US dollar and the euro. Consequently, the GFC has represented an unanticipated opportunity for East-Asian currencies and countries in general and for China in particular. When the latest

[1] The main arguments during the 1990s were that high post-WWII growth rates in Asian countries were explained by state-induced high investment rates rather than by total factor productivity improvements and that this model of economic development was unsustainable (Krugman 1994). On the much discussed probable dissolution of the Japanese *keiretsu* in the aftermath of both the 'lost decade' and the 1997 Asian crisis and on the unsustainability of the post-WWII chosen Japanese economic development policy, the interested reader can refer to Ide (1998) and to Cowling and Tomlinson (2000).

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developments in the global monetary system are taken into account (weak type of monetary integration in Europe; weak growth and high risks of deflation in the euro area; renewed attention to a possible multipolar currency system) and when these are combined with recent developments in East-Asia, particularly in China, the question arises as to whether the euro will ever lose its opportunity to be an international currency, to the benefit of other currencies such as the renminbi (RMB). This question will tentatively be explored in this chapter by discussing first the rising importance of Asian financial (currency) markets (section 2) and then the extent to which the GFC represents an opportunity for East-Asian economies, by placing the emphasis on the renminbi (its internationalization) and on China's positioning *vis-à-vis* the euro area (section 3). Some conclusive avenues will be suggested in a last section.

2. The rising importance of Asia in financial (currency) markets

Financial markets broadly encompass stock markets, including venture capital and private equity, government and corporate bonds markets, as well as real estate markets. The depth of financial markets depends on the economic size of an economy as well as on its degree of economic liberalization. In emerging countries such as China, the structure of financial markets differs from that of their industrialized counterparts in a number of ways, including: the range of assets available to private agents is limited; securities markets are under-developed; capital controls hinder the ability of domestic agents to old foreign assets. These markets are characterized by 'financial repression' or by government policies restricting and controlling their smooth functioning (Bumann *et. al.* 2013). A first common criterion measuring the depth of financial markets is for example the stock market capitalization to GDP ratio. Before the global financial crisis (in 2006), and according to World Bank World Development Indicators data combined with Standard & Poor data, this ratio reached more than 89 per cent for China and more than 80 per cent for the euro area, against 46.3 per cent and 42.4 per cent in 2011 respectively. Judging by this sole criterion, the economic reforms in China have been successful in changing the nature of assets' ownership through privatization and industrial restructuring.

Of particular relevance at this juncture has been the interconnection between East-Asian countries (lately, of China) with Western countries in the government bonds markets, and the increased frustration from the part of Chinese monetary authorities with the US quantitative easing policy and the ensuing depreciation of US dollar denominated assets such as the US Treasury Bonds. As can be seen in Figures 1.a and 1.b, the three currencies under review (RMB, yen and Korean won) have been appreciating *vis-à-vis* both the euro and the US$, since 2004 for the RMB and since 2007 for the Japanese yen and up until 2011/12. In particular, the steady appreciation of the RMB *vis-à-vis* both the US dollar and the euro has enabled the alleged problem of exchange rate manipulation (or misalignment) by the Chinese authorities to abate[2]. The impact of 'Abenomics' since December 2012 can easily be seen through the depreciating Japanese yen with regard to the euro.

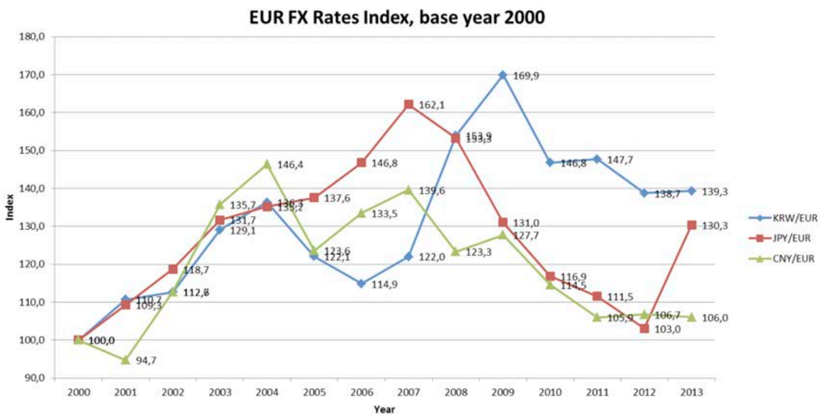

Figure 1.a – EUR FX Rates Index, base year 2000.

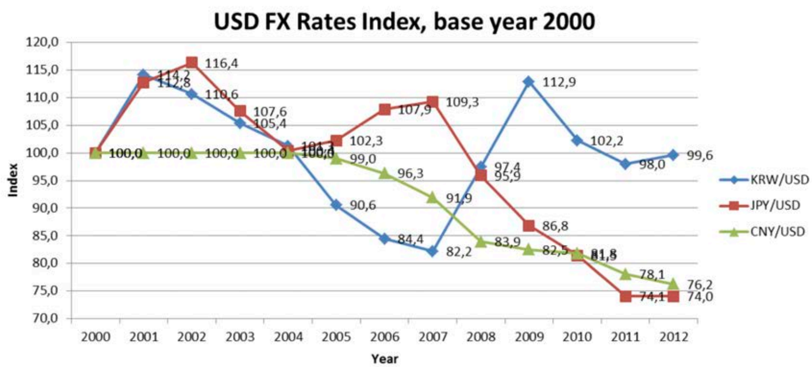

Figure 1.b – USD FX Rates Index, base year 2000. Source: ECB Statistical warehouse, own indexation.

The increasing strength of East-Asian currencies, in particular of the RMB, has been paralled with the favourable trading position of these countries, in particular with the large current account surplus of China since the economic reforms were given a new impetus by Deng Xiaoping in 1992. China's economic size in both GDP and trade terms makes the country's currency an increasingly ideal candidate for acquiring international currency status[3].

2 On a good analysis relating to the debate on exchange rate manipulation, see Cheung (2012).

3 According to EUROSTAT 2013 figures, the GDP of China amounted to 8.227 trillion US dollar in 2012; this is about half that of the EU's (at 16.566 trillion) and of the USA's (at 15.68 trillion).

Beyond GDP and trade, the third determinant of international currency status is financial depth and strength; this is a weak point for China today but this is precisely the area where much of Chinese economic policy has been focusing since the mid-1990s. As will be seen below (section 3), the many initiatives taken by the Chinese government, particularly since the 2000s, have been aimed at enhancing the attractiveness of the RMB by foreign private and official economic agents. From the standpoint of the Chinese government, allowing the RMB to become a much sought-after international currency would convey a number of well-known advantages. These would emanate from the ability of the Chinese economic system to lessen its dependence from the US dollar and this would allow China to 'monetize' its debt, and therefore to benefit from its 'seigniorage' position in the area of monetary policy.

The large Chinese current account surplus led to growing foreign exchange reserves by the Chinese banking system through the internationalization of increasingly restructured State-Owned-Enterprises. As of December 2013, IMF sources estimated the foreign exchange reserves excluding gold detained by the People's Bank of China at 3.8 trillion US$. The corollary of increased foreign reserves by the Chinese banking system and of an appreciating RMB has been a diminishing role of both the US dollar and euro on international currency markets. Figure 2 shows indeed the sliding role of both the US dollar and euro since 2009; although a large share of allocated foreign exchange reserves are apparently still in US dollar, this graph shows that this share has inexorably been declining over a ten year period of time, to the benefit of other currencies, including the Japanese yen.

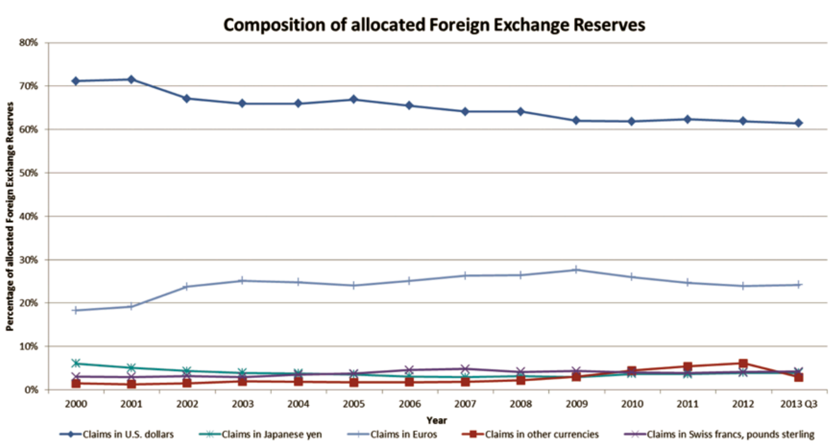

Figure 2 – Composition of allocated Foreign Exchange Reserves. Source: Derived from IMF COFER database (allocated FERs exclude gold).

Table 1 – Market Shares of Top Banks (2010 and 31st March 2013).

% share of top 30 banks worldwide	China		Japan		Euro Area		UK	
	2010	2013	2010	2013	2010	2013	2010	2013
Assets (based on US$ tr)	21	-	5	-	13	-	15	
Market Capitalization (based on US$ bn)	35	22	3	7	8	6	18	12

Source: Derived from the International Directory of Banks, Press Releases of Banks, <http://www.banksdaily.com/topbanks/World/2013.html>.

Another revealing indicator that sheds some light on the favourable performance of the East-Asian financial system, when compared to the euro-area system, is in terms of the banks' global market shares, as depicted by Table 1. Despite its imperfect, heavily controlled and relatively closed banking systems, China's banks manage to represent more than a fifth of the top 30 banks' market capitalization in 2013.

It is clear that the third economy in the world in GDP terms has increasingly been able to carve itself a niche in international financial markets, in spite of the Chinese financial system not being fully developed and not fully functioning on market-based principles. To these issues we now turn.

3. The crisis as an opportunity for East-Asian (Chinese) currencies and financial systems

Financial crises have become a 'normal' occurrence in our increasingly open economic system with 75 per cent of all IMF members having suffered from a financial crisis between 1980 and 1996 (Lindgren *et al*. 1996). Of specific significance has been the 1997 Asian Financial Crisis, not just because it has temporarily jeopardized economic growth in the most dynamic region of the world at the time, but even more so because it has brought with it some substantial institutional change. First, it has led to important regulatory reforms in South Korea, one of the countries at the epicentre of the crisis (Naughton 2007; Ha, Wang 2007). Second, it has stirred a very enthusiastic debate about the feasibility of regional monetary integration in East-Asia (Moon, Rhee 2012). In particular, the Japanese proposal for the establishment of an Asian Monetary Fund (AMF) proved eloquently to the rest of the world that the East and South-East-Asian monetary authorities were keen to intensify financial solidarity at the regional level. The ensuing Chiang Mai Initiative (CMI), a watered-down version of the AMF, was an emergency regional funding arrangement created at the regional level and it provided for a financial safety net at the level of the region[4]. In spite of its limitations, it can nevertheless be inferred that the very creation of the CMI as a safety net at the level of the Asian region has enabled these countries to emancipate themselves *vis-à-vis* the Bretton Woods institutions. The next step on this path to a greater financial emancipation was to be represented by the GFC.

3.1 The GFC as an opportunity for the East-Asian economies (China)

Even more so than the AFC, the GFC unveiled the Chinese and East-Asian distrust *vis-à-vis* a US dollar-based monetary and financial system. The 2009 proposal by the Governor of the People's Bank of China for Special Drawing Rights as a substitute to the US$ in the short run is testimony to that. The GFC is therefore seen as an opportunity to develop and consolidate various financial centres in East-Asia such as Shanghai, but also Seoul, with the development of the Seoul International Finance Center; in particular, Shanghai would compete with Wall Street and the City by 2020 (Otero-Iglesias 2010; Barth *et al.* 2012). A core element in this strategy of developing the depth and breadth of East-Asian, in particular of Chinese, financial systems is the internationalization of the RMB, as reiterated for example in the November 2013 plenary session of the 18th Central Committee of China's Communist Party (Third Party Plenum).

It should be noted that several steps towards the internationalization of the RMB were taken before the GFC. During the 1990s, these consisted in developing the stock exchange markets in Shanghai and Shenzhen, with Shanghai aimed at becoming a regional hub of financial intermediation. This has greatly contributed to the emergence of a quasi-private Chinese market in financial services. Already in July 2005, the opening of the capital account had allowed Chinese public pension funds and other strategic vehicles to invest abroad. Other steps before the GFC included also: the increasing use of the RMB as an invoice currency in international trade with partner countries in the region allowing since 2005 the RMB to overtake gradually the US$ as the exchange rate anchor currency in East-Asia (Campanella 2014)[5]; and the

[4] The CMI is a swap agreement (US $ for local currencies) and works on the basis of pooled reserves. The funds available have been increased with the 'multi-lateralization' of this safety net (CMIM). The continuing accumulation of foreign reserves by the various countries in the region, and the connection of the CMIM to the IMF might suggest that this emergency regional funding arrangement has fallen short of its ambitious objective (Ryan 2013).

[5] Note that the year 2004 is important in the domain of monetary reform in China. Since that time, the conduct of monetary policy by the People's Bank of China (PBC) has shifted from a direct control approach towards interest rate liberalization, a more flexible RMB exchange rate, and breakthroughs in financial institutions reforms. For more on these issues, see Xie (2004) and Hossain (2009).

development of bonds and derivatives markets with the idea of establishing and developing CDSs markets in the future[6]. The internationalization of the RMB in Asia has happened through off-shore centres without the RMB being fully convertible, given the still prevailing existence of capital controls. In particular, Hong Kong, as a crucial laboratory case in the strategy of internationalization of the RMB in the region, has been a growing RMB denominated bond market (Otero-Iglesias 2010).

These first initiatives have been given an impetus by the GFC, for since the onset of the crisis, more steps have been taken in that direction, in particular towards the internationalization of the RMB beyond Asia. In particular and because the financial crisis manifested itself first as a liquidity crisis, China bilateral swaps agreements with countries in the region such as South Korea, Malaysia, Hong Kong and Indonesia have been accelerated, but these swaps have also involved countries further afield such as Belarus and Argentina (in March 2009) and Iceland (in June 2010). With regard to the euro area, the Chinese financial authorities have been using Luxembourg as the euro-area hub for the internationalization of their currency. Luxembourg has indeed become the most important RMB center in the euro area and in Europe with 56bn in RMB deposits and 67bn in loans (PwC Luxembourg 2013). Three of the four 'big 4' Chinese banks (namely the BoC, ICBC and CCB)[7] use Luxembourg to expand their network throughout the EU.

As a result and according to the BIS Triennial Central Bank Survey of Foreign Exchange Activity in 2013, the RMB became one of the 10 most traded currencies in the world in 2013, jumping from the 17th place to the ninth place in the space of only three years. According to the Bank for International Settlements, this commendable performance is explained by the rapid growth of offshore RMB trading, including in the EU. The growing influence of East-Asia (of China) in global financial markets will, in time, lead to the reshuffling of the architecture of international monetary relations. Of critical importance are therefore the RMB-euro relations.

[6] China's securitization pilot program started in 2005 and was temporarily halted in 2009. In the area of credit derivatives such as credit default swaps (CDSs), China's policy has been to favour its own version of CDSs with the introduction (in October 2010) of Credit Risk Mitigation Contracts, which are non-tradable agreements between two parties, and of Credit Risk Mitigation Warrants, which are transferable instruments similar to credit-linked notes. These Credit Risk Mitigation products differ from CDSs in a number of ways: their structure is simpler as they are based on inter-bank liquid bonds; and a central clearing mechanism avoids over expansion of these instruments and allows to contain systemic risk (You *et al.* 2012).

[7] The 'big 4' are: the Bank of China (BoC); China Construction Bank (CCB); the Agricultural Bank of China (ABC); and the Industrial and Commercial Bank of China (ICBC).

3.2 China's positioning *vis-à-vis* the euro area and the challenges ahead

The question as to where exactly the delineation of a new multipolar currency world leaves the euro is beyond the scope of this chapter[8]. Of more immediate concern is the type of China-euro area financial relation that has been evolving since the GFC, primarily through the China Investment Corporation (CIC), one of the largest sovereign wealth funds in the world, as well as through a number of reformed State-Owned Enterprises (SOEs). The Chinese strategy of diversification away from US$-denominated assets explains the Chinese penetration through the distressed periphery; this led for example China Three Gorges Corporation buying 21 per cent of the shares in Energia de Portugal in December 2011, the Chinese SINOPEC Group (China Petrochemical Corporation) buying 40 per cent of the Spanish Repsol's Brazilian subsidiary (PetroChem) and this explained other Chinese strategic investments in the EU distressed periphery since 2008. In the financial area, the increasing dependency of crisis-stricken EU peripheral countries on China in the sovereign bond market has been reported across different media. For example, according to «Il Sole 24 Ore» (Longo 2011), the Chinese monetary authorities approached EU countries first on an individual basis by offering to buy Greek bonds in October 2010. By Spring 2011, Chinese investors owned 10 per cent and 13 per cent of the Spanish and Italian sovereign debts respectively. Subsequently, after much debate on what should be done in order to restore confidence in the euro area, the visit to Beijing by the Chief Executive Officer of the European Financial Stability Facility (EFSF) in October 2011 showed the EU willingness to see China play an important role in the bailing out exercise of the euro area by injecting even more funds into the euro area through the newly-born «financial safety net»[9]. Whilst figures on the exact composition of euro area members' sovereign debts are not in the public domain, it is nevertheless possible to infer that both the type and size of interconnections between China and the euro area in the sovereign bonds market are unprecedented. A natural question unfolds at this stage: what is the price to pay in return? According to some authors, it could be a strengthening of the Chinese position on the market economy status (Casarini 2011).

Obviously, the strategy of RMB internationalization is not without risks, for the Chinese financial system itself and within the region as a whole.

[8] See for example the articles by Dailami and Masson (2009) and Campanella (2014) for more on the delineation of a new world currency regime.

[9] By October 2011, Asian investors had already bought some 40 per cent of EU EFSF bonds (Rabinovitch 2011).

3.3 Risks emanating from the RMB internationalization strategy

Since the GFC, the enthusiastic debate about monetary integration in East-Asia after the AFC seems to have moved back stage, diminishing thereby the likelihood of a common regional currency that could 'contain' the RMB. Consequently, having the RMB standing out as the main currency in the region could by resented by China's immediate neighbours, in particular by Japan and South Korea. Second, in spite of all the efforts towards liberalization (efforts fostered in particular by WTO membership) the internationalization of the RMB has been done through the back door and there has been little change with regard to the control exercised by the People's Bank of China (i.e. by China's Communist Party – CCP) on both the sector and on regulatory bodies. The CCP still has a substantial influence in all areas, by appointing top managers of the big banks for example. As argued by Andreosso-O'Callaghan and Gottwald (2013), interest and exchange rates are still distorted, State Owned Enterprises – even though substantially reformed – still avail of a preferential treatment in the allocation of banks' loans, and the banking sector is relatively concentrated with the 'big 4' state owned banks still representing a large share of total banking assets. The Chinese government's reluctance to remove all capital controls (that would 'unbridle the horse' and increase 'systemic risks') could also ignite tensions with Western countries, in particular with the EU.

Finally, the diminishing reliance on banks for credit (with only 58 per cent of all financing in 2012, according to Natixis 2013) and the parallel increased reliance on new financial actors and on shadow banking, coupled with the unresolved problem of non-performing loans despite the creation in 1999 of four Asset Management Agencies, imply that the Chinese financial system is more than ever prone to systemic risks and that the RMB could be a victim of its own success.

4. Conclusions

In terms of Western-East-Asia (China) monetary relations, the Global Financial Crisis has had a dual and inter-connected impact: it first exposed the limitations of Western-based financial institutions, and second, it 'unbridled' the Chinese leadership's aspiration to internationalize further the RMB, allowing Beijing some scope to fulfill eventually its long-term ambition which is to replace the US$ by the RMB as a (the?) major international currency.

The continuing quantitative easing policy of the US Federal Reserve and the ensuing depreciation of US$-denominated assets held by Chinese economic agents, combined with uncertainty in the euro area five years after the crisis, are all ingredients for the delineation of a new world (perhaps multilateral) currency regime. Steps towards the internationalization of the RMB were taken well before the GFC and they consisted mostly in a 'regionalization strategy' through off-shore centres, such as Hong Kong, without the RMB being nevertheless fully convertible. This regionalization strategy is logically connected with the greater involvement of China in the region (through trade in particular), a phenomenon that has been very much facilitated by China's free trade policy with neighbouring countries[10]. As a result, the RMB has become East and South-East-Asia's new reference currency and is becoming *de facto* a global reserve currency.

The euro-area leaders' inability to proffer adequate and timely responses to the 2008 euro-crisis has represented an opportunity for the Chinese policy of RMB internationalization. In terms of currency internationalization, Luxembourg plays today in Europe for the RMB the same role as London played in the past for the US$. The GFC also gave an impetus to the Chinese 'go global' strategy that has been in full swing particularly in the EU distressed periphery and in EU sovereign bonds markets.

These developments leave a number of questions open. A most pressing issue is the question as to whether the euro might still become a credible international currency in the near future and might therefore share the role of the US$ (and of the RMB) in a new global monetary architecture. Another difficult question relates to the long-term strategy of the Chinese government in the area of global monetary and economic relations. For example, by becoming an increasingly important creditor, in the West in general and in the euro area in particular, China might aim at splitting the EU-US anti RMB front; this 'Machiavellian' strategy would certainly make the rise of the RMB as an international currency much easier[11].

These global considerations ought therefore to inform future monetary policy-making at EU level, calling for urgent reforms, in particular of the euro and of governance at the level of the EU institutions. Without such reforms, the alternative might be a "Beijing Consensus" in global currency markets, or simply, retrenchment.

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[10] In this vein, one can mention the coming into effect of the China's Free Trade Area with the Association of South Asian Nations in 2010.

[11] So would monetary disintegration in the EU, obviously.

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Global Currency-Regional Currency: The Institutional Structure of the EMU and the Legacy of the Sovereign Debt Crisis

Antonia Calvo Hornero

1. Introduction*

After years of pursuing greater economic, financial and monetary cohesion through the single market and the strategic economic and social cohesion programmes which followed the signature of the Single European Act in 1987, the euro is the most visible sign of European identity and political integration. The introduction of the euro had a political basis, since it would not have been possible without the cooperation of the political leaders of the Member States who decided to take on the responsibilities implied by the Economic and Monetary Union (EMU). However, it also had a clear economic objective, based on the pursuit of a greater regional economic integration within the framework of greater cohesion at European level. When the single currency was designed, a prior political integration programme was displaced, in addition to the creation of a single supranational organism, similar to a State, which would preserve the sovereignty and diversity of the Member States. Instead, a high degree of joint decision making, based on coordination, was chosen.

After many long years searching for a greater monetary cohesion in Europe, and following the European Monetary System (EMS) experience, the plan for an Economic and Monetary Union and an exclusively European common currency represented one of the greatest achievements, not only at European level, but also at international level following the end of the Bretton Woods system. It is no wonder that enthusiasm for the project made criticism of the underlying uncertainty regarding the structural and institutional aspects of such a complex project fade into the background. The nar-

* This article reflects the existing situation in the EMU in mid-2013, closing date of the data.

Max Guderzo and Andrea Bosco (edited by), *A Monetary Hope for Europe: the Euro and the Struggle for the Creation of a New Global Currency* ISBN 978-88-6655-965-8 (print) ISBN 978-88-6655-966-5 (online)

row concept of the new monetary institutions of the EMU (ECB and ESCB) in the Treaty, which gives the European Central Bank (ECB) almost exclusive power over monetary policy, led to uncertainty about several basic issues closely related to monetary policy. These doubts came increasingly to the fore with the crisis, leading to clear conflict between different political stances regarding the responsibilities of the ECB during the crisis.

While the governing bodies of the ECB reflected on the appropriate monetary measures, an intense debate was simultaneously developing in the political decision-making arena of the European institutions. It was particularly lively in the governing bodies and forums of the Eurosystem, where the institutional and decision-making problems of the Eurozone became evident.

In spite of the criticism and with all its defects, now that the direst moments of the crisis have been overcome, the euro remains one of the primary pillars of European integration and the organization and operation of the international monetary and financial system. The single currency is indeed one of the most important reserve currencies in the globalized world sharing a privileged position among regional currencies with the renmimbi.

The aim of this article is to describe what causes a currency to be considered regional or global and the effects of the sovereign debt crisis on the EMU and particularly on the structural institution that supports the Eurozone and the euro.

2. Uncertainty and criticism of the single currency

The idea of the creation of a single currency not only caused uncertainty regarding economic and monetary issues, but also raised doubts about whether new governments resulting from future national elections would share the philosophy that encouraged Europe's political leaders to sign the Maastricht Treaty.

However, criticism focused mainly on the economic area. The creation of a single currency was an idea without precedent in the international monetary system. It entailed the establishment of new supranational institutions such as the ECB, the work of which was bound to be regarded with a certain distrust, at least to begin with. Firstly, due to the lack of experience of the new institution and secondly, because the economic cycle is not identical in all countries of the Eurozone and nor is the most convenient price of money.

Another uncertainty related to the need to ensure the financial stability of the EMU, particularly because, faced with the unavoidable need to reduce costs, it was expected that the restructuring of the European banking system would be favoured. This could encourage inefficient institutions to maintain high-risk transactions and activities to compensate for their inefficiencies, thereby putting the rest of the Eurozone financial system at risk. The financial supervision functions were not assigned to the ECB nor to the European System of Central Banks (ESCB), although Article 105(4,5,6) of the EU Treaty and Article 25.1 of the ESCB by-laws assign to the latter some functions relating to the supervision and stability of the financial system. The annual report of the European Monetary Institute (EMI) for 1997 points out that the primary objective of these functions was to ensure an efficient interaction between the ESCB and the national supervisory authorities.

Likewise, responsibility for providing liquidity to individual financial institutions, that is, the role of lender of last resort which is played by national central banks, was not assigned to any single currency institution in the case of a crisis. All these aspects are part of the expected reform of the EMU organization highlighted by the sovereign debt crisis. Two further points should be expressly noted: first, the absence of a shared sovereignty among the Member States and the European institutions on fiscal matters and second, an unclear system of governance. All these elements have contributed to lengthening the crisis and to the speculations and criticism originating in the malfunction of the Eurosystem.

3. A financial crisis in an international monetary system without express rules

Over the past twenty years the international economy has experienced an intense process of financial integration. This has been characterized by the notable increase in international flow of capital and the existence of an international monetary system without rules of operation and with no supranational organism to supervise it. Confidence in the market's disciplinary capacity to create stability and equilibrium has been eroded by the international financial crisis, which burst forcefully into this complex global financial situation.

However, unlike previous international monetary systems, the current system not only lacks specific rules but also comprises a set of fixed and flexible exchange rate systems distributed through the international exchange scene and based on countries' economic development. Under the Bretton Woods regime, the rules and mechanisms which dominated the system were the result of international agreements. Conversely, most of the procedures and policies underpinning the operation of the current international monetary system are the result of unilateral decisions made by individual countries, large financial conglomerates and what are vaguely referred to as 'market forces'.

In general, countries belonging to the various regional areas, as defined by their economic and strategic decisions, tend more towards fixed exchange rates within each area. Some peg their currencies to the dollar, as is the case with the primary oil-exporting countries in the Middle East or in certain countries in Southeast Asia. The same is true of Central and Eastern Europe with countries that peg their currency to the euro, in particular States which are candidates or potential candidates for EU accession. In the case of the euro, countries in the CFA franc area should also be included. Russia pegs its currency to a euro-heavy currency basket.

With the exception of China, the liberalization of the movement of capital since the beginning of the 1990s (in the EU since 1 July 1990) is considered another element characterizing the current international monetary system. The elimination of restrictions to the entry and exit of capital has become the force behind the exchange rate. Over the past few years many emerging markets have followed a strategy of accumulation for international reserves, generally in response to periods of financial instability. The primary reason is to have sufficient resources for sporadic foreign liquidity problems and a potential modulation of the variations in the exchange rate. In this way, international reserves would play a stabilizing role in the context of a global financial crisis when faced with the possibility of loss of foreign financing.

Currency reserves have also increased notably since the start of globalization, particularly in certain countries where currency is still somehow pegged to the dollar. Another significant aspect of the current international monetary and financial systems is the close relation between the two, to the extent that people now tend to speak more about the financial than about the monetary system. The development of internal financial markets that favour financial innovation and delve into such markets, together with the development of information technology and the knowledge that facilitates real-time online operations at any hour of the day, have made a major contribution to the development and mobilization of foreign investment and brokering transactions.

4. A tripolar international monetary system?

One of the questions most frequently asked by international financial analysts is whether we are in the presence of a tripolar international monetary system, based on the dollar as a global reference currency and the euro and the renmimbi in their respective regions. The situation was different in the 1990s, when Europe still had the EMS, and in Asia Japan was the economy of reference for the region at international level.

In an earlier article I considered the possibility of a tripolar realignment of the EMS as a valid alternative for a more stable future international monetary system (Calvo 1994). This would entail commitments to flexible exchange among monetary blocs and to discipline regarding exchange rates in countries representing each regional economic area. The article argued that the United States, the leadership position of which was indisputable in the Bretton Woods era, had yielded to a greater participation of Europe and of Japan and other Asian countries, the economies of which had been rapidly expanding. All this favoured the creation of a tripolar international monetary system centred on these three large economic blocs. Although the shared supremacy which I predicted at the time has not come about, what remains is the leadership of the dollar as supreme currency, and of Europe, in this case with the single European currency. In Asia, Japan has been displaced by the momentum of China and its economic and commercial power.

This can be explained by the fact that, from the mid-1980s to the late 1990s, Japan made decisions regarding the opening of financial accounts and capital. It also implemented a series of policies geared towards driving Tokyo as one of the major international financial centres, as well as supporting the role of the yen in financial transactions and in the area of international business. These efforts short-circuited with the decline of the Japanese economy and the relative loss of relevance in the international context. This happened despite the efforts of the American Treasury to jumpstart a greater flow of capital currents towards Japan to favour the appreciation of the Japanese currency in the face of an unfavourable bilateral imbalance in the balance of payments between the United States and Japan.

This first attempt to support the yen as an international reserve currency in the context of financial reform in Japan was frustrated by the start of the Japanese asset price bubble in the early 1990s. At the end of the decade there was a renewed effort to boost the economy through reform proposals. However, despite the completion of the liberalization of the capital account and financial accounts, efforts to achieve a greater internationalization of the yen appear to have been abandoned early in the following decade (2003).

The financial crisis has reopened the debate on whether central banks in emerging countries, e.g. large holders of reserves in Asia and the oil-exporting countries, can diversify their holdings of currencies other than the active traditional reserves, including assets financially denominated in US dollars. Frankel (2013) and Prassad (2014) consequently consider that the crisis has underlined the strength of the dollar as a reserve currency, and its share in global reserves has not changed even though a rating agency lowered the sovereign debt rating. Apropos keeping the euro in global reserves, confidence in the long-term stability of the euro area and hence the limited impact of the crisis on the euro as an international reserve is also highlighted. The same can be said for other non-traditional reserve currencies such as the Australian dollar, the Canadian dollar or the renminbi itself (ECB 2013a).

The question that arises today is whether a more diversified international monetary system or a multipolar system with a number of international currencies – in which the dollar, the euro and possibly the renminbi and other currencies play similar roles – would be a stable or unstable system for financial and international market exchange. Would a multipolar monetary system help solve the dilemma of Triffin (Farhi *et al.* 2011) and the shortage of secure reserves? Some believe that the growing concern with the substitutability between currencies favours instability in financial market exchange and that a multipolar global monetary system would interact between private and official investors, each with their own interests, essentially anticipating the crisis and without its riskier holdings. Furthermore, any system would have to be gradually implemented and adopted, adapting to the new situation and revealing its operational potential and the corrections necessary for the better functioning of the new mechanism.

To differentiate the role of a regional currency from that of a global currency, the internationally-accepted rules of operation which allow a currency to be considered as global currency and as regional currency are set out below.

5. The rules of operation of a global currency

The commonly accepted roles of a currency are as a unit of account, a medium of exchange and a store of value. As a unit of account, it is used to guarantee international financial transactions, in international commerce, in the international price of merchandise, in prices and even as a parallel currency or reserve currency in the various existing exchange rate regimes. As a medium of exchange, it is used as a vehicle in foreign currency exchange markets, the settling of international commercial and financial operations, as a parallel currency and in official financial flows or in official intervention in exchange markets. As a store of value, it is used as an international financial asset in foreign currency reserves, a parallel currency or to maintain international financial assets.

Since the Bretton Woods collapse, the international monetary system lacks a set of express and officially-agreed rules of operation. Therefore, in the absence of a regulated international monetary system, in order to identify the rules of operation of a global currency we shall take into account the following: (1) the underlying economy behind the currency; (2) the roles of the currency or its markets; (3) the institutional structure which supports the currency; (4) other considerations, i.e. (a) the influence of the country in international economic organizations; (b) the availability of other investment alternatives, commerce and business; (c) the global influence of the issuer, including its military power.

In all the foregoing aspects, the US dollar still comes out on top, backed by the largest global economy, the broadest, deepest and most liquid markets, the advantages that come from the existence of structural externalities in the use of that currency and the use of and trust in that currency throughout the world. Taking these considerations into account, it is a fact that the dollar is still considered the quintessential global currency despite the notable imbalances, both internal and external, of the American economy in past years which have not ousted the preference for the use of the dollar as a global currency.

Among the reasons we can cite to justify the global use of the dollar, despite the structural imbalances of the American economy, are: the confidence that the American economy will not go bankrupt due to its size, the legal certainty that supports it, the political power of the United States and, above all, the fact that the advantages of the use of the dollar have so far outweighed what the imbalances represent.

Regarding the monetary and institutional structure that supports the confidence in a global currency such as the dollar, the following may be noted: (1) the existence of a central bank that acts as lender of last resort and is committed to price stability and promoting economic development and employment; (2) an evolved financial system, which is diversified, globally spread and appropriately and uniformly regulated and supervised; (3) a centralized budget to address asymmetrical shock.

Expanding on the example of the American dollar, the Federal Reserve of the United States (FED) is subject to the Humphrey-Hawkins Act of 1978. This includes among its primary objectives: price stability, promoting the maximum level of employment (defined by law as an unemployment level equal to or less than 4%) and moderate long-term interest rates. The FED is less independent than the ECB, since Congress can reject its decisions through a law and with the approval of the President. This is not anticipated in the Eurosystem.

These characteristics have allowed the dollar to continue to maintain its place as global currency, with an absolute predominance in the composition of official currency reserves, although a number of currencies (including the yen, the renminbi, the Canadian dollar and the Swiss franc) have emerged as regional currencies. The euro has maintained its absolute presence since its creation, although in official reserves worldwide the combined portion of dollar plus euro is lower and decreases in comparison to the rest of the official reserve currencies taken as a whole.

6. The rules of operation of a regional currency

A regional currency is the legal tender issued by the monetary authority of a country or common monetary area. We will distinguish two different situations: (1) currency which differs from a global currency solely because of the area in which it is issued or used (e.g. the renminbi); and (2) currency which is issued or used by an authority acting as such because it belongs to a monetary area (e.g. the euro).

In order to consider the rules of operation of a regional currency, we will follow the same methodology as described above for a global currency. According to this approach, we assume the characteristics and conditioning factors of a regional currency to be similar to those of a global currency: the same functions as any other currency (unit of account, a medium of exchange and a store of value); the economy and its role in exchange markets; and, as a currency of reference in international commerce, its use as a reserve asset for transactions, intervention, investments and preventive requirements.

The primary difference between a global currency and a regional currency is based on the limited role a regional currency plays in foreign exchange markets compared to the primary currencies in those markets. In other words, the regional currency fulfils similar functions in the regional area to those a global currency does in the rest of the world. As regards the Eurozone, however, it should be noted that, although the euro is a regional currency it should be considered a special case for the reasons outlined below.

7. The role of the euro as a regional currency

Upon the introduction of the euro in 1999 there was a broad consensus that it would be well received internationally in its various roles and in its consideration as a global currency for use by the private sector and by official institutions, particularly in its role as a reserve currency and its use in international bond markets. However, from a theoretical standpoint, there were essentially two positions. Some authors advocated the emergence of the euro as a global currency but thought it would be established as such gradually, not as a direct rival of the US dollar. Others expected the euro to become an important international currency, considering the relative size of the European economy, the commercial ties the European Union maintains with the rest of the world and the belief that the EMU would be an important stimulus for the integration, growth and development of the Eurozone.

Since its creation, the euro as a regional currency has played a very important role as an anchor or reference currency in the foreign exchange rate regimes of about 40 countries. The roles are concentrated mainly in neighbouring countries of the regional area and countries with economic and political ties to the EU, either between Eurozone countries and non-EU countries, between non-EU countries and as a parallel currency in non-EU countries.

The majority of those countries are geographically close to the Eurozone, including most of the EU countries which do not belong to it (ECB 2011, 2012, 2013b, 2014). The euro is also the subject of special institutional agreements involving candidate States, potential candidate States, CFA zone countries and countries, such as Russia, which for commercial relations maintain a currency basket in which the euro weighs quite heavily.

If we consider the EU countries that do not yet belong to the Eurozone, we can distinguish: (1) participation in the ERM II Exchange mechanism, e.g. Denmark; (2) binding agreements with trading ranges based on the euro, e.g. Hungary; and (3) currency boards based on the euro, e.g. Bulgaria. In potential member candidates and candidate States for EU adhesion, we can distinguish countries (ECB 2013b) which maintain: (1) a unilateral euroization, as in the case of Montenegro; (2) a currency board in Bosnia and Herzegovina; and (3) a binding agreement or floating exchange regime with the euro as currency of reference, as in the case of Serbia or Croatia (which recently joined the EU). Among other ways in which the euro is used as reference, we can mention the euroization of Vatican City or the unilateral euroization of Andorra.

The ECB maintains a neutral stance on the international use of the single currency, officially considering that this use is determined primarily by market forces. However, the ECB closely monitors the use and influence of the euro in the international economy by publishing an annual report, *The International Role of the Euro*. The scope covers not only the demand for euros for debt in the sovereign debt crisis, but also the overall impact of diversification of official reserves and development in bond issues in foreign currency (ECB 2014).

8. The institutional structure of the EMU and the system of governance

As previously discussed, the institutional structure is the essence of the viability of a currency. It is also essential in determining whether a currency will be able to become a global currency or remain a regional currency.

The EMU system was designed with two different components: the Monetary Union and the Economic Union, which were to evolve simultaneously. The Monetary Union relies on the ECB as the Central Bank of the Eurozone countries, with a monetary policy strategy based on a monetary aggregate and on a quantitative definition of the goal of stabilizing prices (annual growth of the harmonized consumer price index for the euro area below 2%). The ECB should not be involved in a political system operating through power or institutional motivations. The Economic Union is based on the coordination of macroeconomic policies with agreed rules for budgetary policies. It has to combine the characteristics of a common market with the essential rules for its operation, with an elevated degree of market freedom and private initiative between the monetary and economic components to ensure that the EMU is viable.

The decision-making process in the Eurosystem is related to the system of governance provided by the Union, which implies adaptation of the institutions and practices governing economic and monetary decisions to improve its operation and image at international scale. As for the EMU, the Maastricht Treaty created a decision-making system structured around four main pillars constituting its system of governance: monetary governance, fiscal governance, structural policy governance and international governance. Of these four pillars, only monetary governance is regulated by an independent institution: the ECB. The rest of the organisms and institutions are composed of government representatives who defend their national interests, and when large countries try to establish the course of action they feel that the others ought to follow.

This means that we can differentiate two distinct areas in the EMU decision-making process: on the one hand, a technical area which is independent of the national authorities represented by the ECB and has a broad perspective of the operation of the Eurozone; on the other hand, the area where the governments and high-ranking officials of the Member States are represented: what we could call the political area.

The technical area consists of the decision-making organs of the ECB – the Governing Council and the Executive Board – which is responsible for EMU monetary policy as well as for guaranteeing the functions entrusted to the ESCB (Article 127, paragraphs 2, 3 and 5 of the Treaty of Rome). The independence of the ECB's decisions means that no member of its basic organs can seek or accept instructions from the institutions, bodies or organs of the EU, or from the governments of Member States, or from any other organism (Article 130 of the Treaty of Rome). In the ECB the maximum decision-making authority lies with the Governing Council, comprised of the six members of the Executive Board and the governors of the central banks of the Member States which use the euro.

The area comprising representatives of the governments of the Member States, what we have called political sector, involves the institutions, bodies and decision-making forums on matters relating to the EMU, such as the European Council, the Economic and Financial Committee (EFC), the Eurogroup, and the Economic and Financial Affairs Council (Ecofin). Of these political decision-making bodies, those that have played the most important role in the crisis have been the European Council and the Eurogroup.

9. The international financial crisis and the Eurozone

The international economic and financial crisis and its consequences on the European Union with the sovereign debt crisis have affected the principles on which the monetary and financial architecture of the Economic and Monetary Union were built. The crisis highlighted primarily the following: (1) the flaws that existed in the governance of the EU and the Eurosystem; (2) the vulnerability of the institutional system on which the single currency area was based; (3) the absence of mechanisms for regulating and monitoring macroeconomic and public finance imbalances in the Eurozone Member States; (4) the fragmentation of the regulation, supervision and exclusion mechanisms of the Eurozone banking systems, (5) the short-term inability of the monetary area to face the consequences of an external impact. The accumulation of all these vulnerabilities, and the slowness of decision-making at institutional level, actively contributed to the scene of confusion that emerged in the EU after May 2010, and to the spread of the crisis infection to the countries considered peripheral to the EU (Greece, Portugal, Ireland and Spain).

The crisis impacted the EU in two phases or periods. A first period, from 2007 to 2009, produced a general impact on the countries of the Union, particularly the northern countries affected by toxic assets in their banking systems. A second phase began in 2010 with the occurrence of the sovereign debt crisis. It was in this second phase that the Eurosystem was seriously affected, the sovereign debt crisis being joined by a crisis in the governance of the Eurosystem and a pronounced asymmetry in the EMU.

10. The vulnerability of the Eurosystem

The international financial crisis affected the whole EU from 2007 to 2009, but after May 2010 it centred on the Eurozone countries, unleashing the sovereign debt crisis. In the first part of the international financial crisis, from 2007 to 2008 (which corresponds to the global financial crisis, in my view), the international response came from the central banks with massive and coordinated interventions from 9 August 2007. In the first part of the crisis the EU suffered institutional, economic, and financial effects. From an institutional standpoint, the consequences on the EU were related primarily to the objectives it had at the time, relating to competition policy, the Stability and Growth Pact (SGP) and the goals of France during its semester of presidency of the EU.

When government aid was proposed to protect the financial system, the objectives of EU competition policy were affected. This aid went against EU fair competition regulations but, due to the urgency of the situation and in order to accelerate emergency plans, it was permitted on a temporary basis and subject to conditions. The regulations of the SGP were also affected from an institutional point of view, since the crisis had become the litmus test for the credibility of the pact. The monetary and budgetary policy was expected to contribute to sustaining demand and not affecting the deterioration of Member States' public finances.

The coordinated UE plan, implemented on 13 October 2008, was the basis of the Member States' commitment to support the financial system. It was essentially a plan devised on the initiative of the United Kingdom, in which Germany pledged to issue 500 billion euros, including 400 billion as security for interbank loans and a 100 billion euro fund to inject capital into financial institutions and acquire non-liquid assets. It was considered the largest peacetime State intervention in the country's economy (the fund drew elements from the *US Troubled Asset Relief Programme*). The German Minister of Finance indeed warned banks of the possibility of government interference in their decisions, including the decision to limit the salary of executives to 500 thousand euro a year, to prohibit bonuses and the distribution of dividends, in addition to imposing the obligation to make loans to small and medium-size companies.

The financial bailout plans had an undesired effect on the real economy of the EU, triggering a vicious cycle in the economy due to the restriction on credit, the fall in consumption demand (which hit the lowest point in decades), a major drop in retail sales and the reduction in investments by companies which, as a preventive measure, dropped projects and opted for liquidity over uncertainty. This economic vicious cycle translated crudely into a strong reduction in employment levels. A year before the Eurosystem sovereign debt crisis blew up in 2008 the recommendations of the Commission and Ecofin were targeted on the need to increase macroeconomic supervision in order to return to a sustainable fiscal position. This implied ignoring bank sector risks, exposure to the real estate sector in some Eurozone Member States and the disorganization and lack of agreement triggered by an inadequate system of governance, which would soon emerge when the

Greek problem exploded after the European Council of March 2010 and especially at the European Council in May.

11. The legacy of the crisis

The sovereign debt crisis in the Eurozone highlighted the deficiencies in the system of economic governance with which the EMU was equipped. As part of the strategy for tackling the consequences of the crisis and improving the economic governance of the Eurozone and at national level, proposals and significant efforts were made to prevent any unsuitable economic and budgetary policies implemented by Member States of the Eurozone from affecting the rest of the Member States of the area and putting the stability of the single currency and the viability of the EMU at risk.

In the area of the Economic Union, important decisions have been made to address the asymmetry between the economic and monetary union. The SGP and the procedure for excess deficit, which since the creation of the euro were expected to ensure restructured public finances in the Member States, have been proved inadequate by the financial crisis. To remedy the deficiencies, several procedures were adopted in 2010-11 to coordinate and guide fiscal policies and to identify the imbalances over time in order to attempt to correct them and improve the coordination of economic policies with the European Semester and the Euro Plus Plan. In December 2011 these measures paved the way for the set of regulations called the 'Six Pack', considered to be the most significant initiative of economic governance in the EU and the Eurozone since the beginning of the Economic and Monetary Union. The intention was to maintain the budgetary discipline and macroeconomic stabilization of the Member States so as to prevent a crisis that could affect the EU. This pattern was further improved through a new package of legislative measures known as 'Two Pack', in force since 30 May 2013.

A Treaty on Stability, Coordination, and Governance was signed in January 2012 by many of the Member States. It contains a Fiscal Pact which reinforces prior commitments existing under the SGP and adds structural equilibrium rules, known as 'debt brakes', at national level in order to prevent fiscal imbalances. Monitoring systems have been set up for early detection of fiscal and macroeconomic imbalances. A group of mechanisms has been put in place for the management of the crisis and financial support, both for EMU Member States (the European Financial Stabilization Mechanism, EFSM, and the European Stability Mechanism, ESM) and for the other EU countries (European Facility for Financial Stability, EFSF). The groundwork has therefore been laid for improved economic cohesion in the EU.

The crisis has also highlighted the interconnection between the financial systems of the Eurozone. To this end, a broad programme of institutional strengthening or governance has been set up, intended to ensure macroeconomic stability and interrupt the nexus between sovereign debt and banking commitment. The programme aims to facilitate the transfer of monetary policy within the Eurozone and end fragmentation in the markets – an objective first broached in the early 1990s. Steps have been taken towards a Single Resolution Fund for Liquidation and a Common Fund for Deposit Guarantee (less specific in this case) in the context of a Pan European Banking Union. This proposal was approved in June 2012, and in October a plan was drawn up for its implementation with a view to the creation of a Single Supervisory Mechanism (SSM). The Banking Union will be one of the most important political integration initiatives of the EU since the creation of the euro, because it affects the national sovereignty of the Member States at various levels.

The Eurozone countries which have been most affected by the pressure of the financial markets have intensified their efforts to recover the confidence of the markets and to perform a period of budgetary consolidation (measured by the variation in structural budgetary balance), particularly countries which have requested financial assistance from the IMF and the EU. Other countries (Spain and Italy among them), which have experienced acute tension in their financial markets and in the risk premium as a result of the sovereign debt crisis, have also performed similar periods.

Through its action the ECB has contributed to containing one-time liquidity and financing problems in the Eurozone, reducing its reference rate, reducing its reserve requirements and, since November 2013, setting the intervention rate at an all-time low of 0.25%. The Bank has intervened in markets and provided unlimited liquidity to banks with a new three-year collateralized refinancing programme and has adopted broad criteria for eligible collateral. All of this has contributed to reducing tension during the crisis and containing the risk of lack of liquidity in distressed banks.

12. Conclusion

The rules of operation of global currencies and regional currencies such as the euro are similar, but the US dollar acts as a global currency on a higher plane: as a super-currency. The sovereign debt crisis has highlighted the imbalances between the Economic Union and the Monetary Union expressed through: (1) the major weaknesses in the governance of the Economic Union; (2) the inadequate macroeconomic and fiscal coordination; (3) the absence of an institutional and decision-making structure capable of addressing the problems posed by the crisis; (4) the strong interconnection between the financial systems of the Member States of the Monetary Union and the relationship between sovereignty and the banking system; and (5) the existence of two zones with different macroeconomic needs: the northern and the southern countries.

Since its creation, the euro as regional currency has played a very prominent role as an anchor or reference currency in the exchange rate regimes of about 40 countries. With the exception of countries in the ERM II, the decision to use the euro as an anchor currency is unilateral and does not in any way imply a commitment by the ECB. Its use is affected by institutional and geographical factors of proximity to the EU, especially in neighbouring euro area countries and in countries that have established institutional arrangements or economic and political ties with the EU or its Member States. Although the euro is often used as a parallel currency in third countries, in Asia and South and Central America the US dollar is still the most used currency.

Since the start of the sovereign debt crisis in May 2010 measures have been taken to alleviate the effects of the international financial crisis on EU Member States and the EMU. This has involved guaranteeing restructured public accounts in each Member State and financial support mechanisms for States and banks in difficulty, and laying the groundwork for improving the governance system with which the EMU was equipped from its beginnings. Therefore, the groundwork has also been laid to improve the economic cohesion of the EU, including an integrated financial framework at European level, greater co-responsibility in designing economic policies, greater fiscal integration and better transparency and accountability. But above all, awareness has increased of the fact of joint responsibility, that it is necessary to create a more appropriate institutional structure endowed with greater coercive power, and that economic governance of the Eurozone requires rapid reform.

In sum, and taking into account the experience of the Eurosystem crisis, I would conclude that: (1) both the size of the European economy and the design of the euro can be equated to a global currency; (2) the institutional structure and the decision-making system set forth in the EMU, particularly in its Economic Union aspect, cannot be equated to a global currency; (3) in the long term, the euro must be equipped with an appropriate institutional structure in order to be considered a global currency; (4) the decision-making system should not produce decisions consistently aligned with the interests of a certain group of Eurozone countries; (5) it is important that, after the reform, the institutional structure ensures compliance by all Member States with a fiscal discipline which fosters growth and wellbeing in all Eurozone countries.

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The Euro as International Currency: Euro-Loans in Central and South-East European Countries

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1. Introduction

The Central and Eastern European (CEE) EU countries have shown a tremendous convergence process in the last decade, resulting in close ties with the core EU Member States. Especially the financial sector was driven by liberalization, integration and cross-country foreign direct investment (FDI; Eller *et al.* 2006). These developments have triggered an unprecedented credit growth throughout the region (Aydin 2008; Liikanen 2012; European Commission 2012). Funding of the catching-up process was to a significant extent financed by core EU countries and the large Western banks with operations in CEE. A significant share of the new bank loans was extended in foreign currency, with the euro as the dominant currency and to a lesser degree the Swiss franc and the US dollar. This development, which is also referred to as euroization, exposes the financial system to a number of additional risk factors (see e.g. Levy-Yeyati 2006; Bordo *et al.* 2010; Haiss, Rainer 2012; Chitu 2012). Especially unhedged borrowers like most households do not have foreign currency income and, thus, are directly exposed to exchange rate fluctuations. The situation is less severe for corporate borrowers, as export revenues can to some degree provide a hedge against adverse currency movements associated with foreign currency debt (ECB 2008; Brown *et al.* 2010).

The 2007 financial crisis led to a materialization of risks associated with foreign currency lending. Across the region, local currencies depreciated significantly against the euro and the Swiss franc, causing stress to unhedged

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foreign currency borrowers. Non-performing loans (NPL) have increased significantly in all CEE EU countries since 2007. These developments raise the question whether foreign currency loans have contributed to the increasing shares of NPLs in CEE EU.

Understanding the impact of foreign currency loans on non-performing loans is important, because of the feedback mechanism of NPLs which can have a negative impact on future growth (see e.g. Espinoza, Prasad 2010; Nkusu 2011; ECB 2011). Klein (2013) investigates the feedback effect for a panel of Central, East and South European countries, showing indications of strong macro-financial linkages. He finds that a positive shock (increase) in NPLs leads to a decrease in GDP growth and an increase in unemployment. If countries with a higher share of foreign currency loans are at risk of recording higher NPLs in crisis situations, policies designed to curtail foreign currency lending might lead to increased financial stability and a smoother catching-up process. Against this background the aim of this paper is to empirically investigate the impact of foreign currency (FX) loans on NPLs in CEE EU countries for the period 2001-2011.

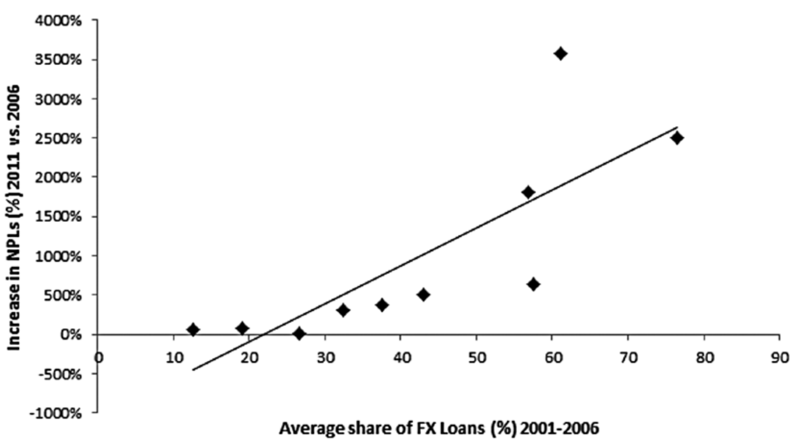

Figure 1 – FX-Loans pre-crisis (2001-2006) vs. increase in NPLs since crisis (2006-2011). Note: Increase in the share of non-performing loans for the period 2006-2011 on the vertical axis. Average share of loans denominated or linked to foreign currency in total loans for the pre-crisis period 2001-2006 on the horizontal axis.

Figure 1 shows that over the period 2007 to 2011 countries with higher shares of foreign currency loans in total loans also recorded a higher share of non-performing loans. In theory, the link between foreign currency loans and non-performing loans seems straightforward. Without any hedging mechanism, exchange rate fluctuations directly impact the interest and principal payment on foreign currency denominated loans. Increasing debt burden in local currency terms leads to increased defaults and non-performing loans.

Hypothesis 1: A higher share of foreign currency loans in total loans is associated with a higher share of non-performing loans in an economy. We argue that this general relationship needs to be refined in two ways. First, a weakening currency increases the burden for foreign currency borrowers. While small fluctuations might not impact the borrower's ability to service the loan, a severe depreciation of the home currency might well lead to a situation where the liability in local currency terms becomes so great that the borrower has to default. Such a situation could e.g. be triggered by an exogenous shock like the current global financial crisis, which has caused significant depreciations of CEE currencies.

Hypothesis 2: The current global economic crisis has triggered significant currency devaluations in Central and Eastern Europe which have had an adverse impact on non-performing loans in the region. Second, we argue that the link between foreign currency loans and non-performing loans depends on the share of unhedged foreign currency borrowers, i.e. whether foreign currency borrowing is mainly to households or corporates. Unhedged foreign currency borrowers are directly impacted by adverse currency movements and thus non-performing loans should be higher in countries with a higher share of unhedged foreign currency borrowers. We argue that households tend to be unhedged, while corporates are at least to some degree hedged by export revenues. Therefore we expect to find a stronger relationship between the level of foreign currency loans and non-performing loans in countries with a high share of household foreign currency loans.

Hypothesis 3: A higher share of household foreign currency loans vs. corporate foreign currency loans is associated with higher share of non-performing loans. The main contribution of this paper lies in investigating directly the impact of foreign currency loans on non-performing loans empirically for CEE EU countries. This is a topic that has implications for the respective countries' path for joining EMU respectively for increasing the global role of the euro; however, it has not received ample empirical attention, with the ECB (2011) and Nkusu (2011) as rare exceptions. Both studies include the nominal exchange rate as explanatory variable of NPLs, which also indirectly measures the impact of foreign currency loans on NPLs. Nkusu (2011) analyses the impact of the nominal exchange rate on NPLs in advanced economies. He argues that a strengthening exchange rate can have mixed implications as it can, on the one hand, weaken the competitiveness of export-oriented firms and, on the other, improve the debt-service capacity of households borrowing in foreign currency. He finds that a one standard deviation shock to the nominal effective exchange rate has a significant negative impact on NPLs. The ECB (2011) shows that in a large panel of 80 countries exchange rate depreciations are linked to non-performing loans in countries with a high degree of unhedged foreign currency borrowers.

The remainder of this paper is structured as follows. Section 2 gives an overview of empirical studies on the macroeconomic determinants of non-performing loans. Section 3 presents the empirical model. The methodology and underlying data are presented in section 4. Section 5 presents the results of the estimations. Section 6 concludes.

2. Stylized facts about foreign-currency loans and NPLs in CEE EU

The common practice of foreign currency lending in most CEE EU countries and the associated risks have been an issue of economic and political debate especially since the onset of the financial crisis. It is widely accepted that high shares of unhedged foreign currency loans in a country expose the financial system to a number of additional risk factors. Ize and Levy-Yeyati (2003) argue that «the degree of loan dollarization determines the financial systems exposure to systemic credit risk in the case of large devaluations». A growing body of literature analyses the determinants of foreign currency lending. Steiner (2011) analyzes the determinants of foreign currency lending to households in Central, Eastern and Southeastern Europe (CESEE) over the period 1995 to 2009. She finds that on the demand side interest rate advantages, rising private sector consumption and rising housing prices contributed to the increase in foreign currency lending. On the supply side, higher interest rate margins on domestic currency loans and banking sector reforms had a mitigating impact. For a further overview of the literature on the determinants of foreign currency lending see e.g. Brown and De Haas (2012), Crespo Cuaresma *et al.* (2011), Fidrmuc *et al.* (2011) or Haiss and Rainer (2012).

The financial crisis that started in 2007 led to the materialization of these risk factors, since many CEE currencies depreciated significantly against the euro and the Swiss franc causing stress to unhedged foreign currency borrowers in the region. Central banks have for some time tried to curtail the growth of foreign currency loans in many CEE countries through monetary tools, as well as regulatory and administrative measures, with limited success (ECB 2011). Against this background the question arises whether the dynamics of foreign currency lending have changed since the onset of the financial crisis.

Figure 2 shows the development of foreign currency lending in the CEE EU countries since 2001. It is evident that the development differs across the individual countries. Foreign currency lending is of relatively low importance in the Czech Republic and Slovakia, with household foreign currency lending virtually nonexistent. On the other hand, in the Baltics about 80%-90% of all loans to the private non-financial sector are denominated in foreign currency, mostly euro. This is not surprising given that the currencies of the Baltic countries have the entire period under investigation been closely tied to the euro (Estonia joined the Eurozone in 2011, Latvia in 2014 and Lithuania in 2015). The adaption of the euro is also evident for Slovakia (2009) and Slovenia (2007).

FX loan growth rates have declined sharply e.g. in Lithuania since 2007/2008. In Hungary, which showed one of the fastest growth rates of foreign currency lending to households before the crisis, the development has similarly flattened out since 2008. There has been no growth in foreign currency lending for the past three years. This is probably due to the severe depreciation of the forint during the crisis as well as strong measures taken by the Hungarian National Bank and rather controversial political measures.

Poland has recorded a rather volatile development of foreign currency lending before the crisis, albeit on a rather low level. After a strong increase particularly by households in 2008, the share of foreign currency loans has stayed relatively stable at around 30% of total loans.

Slovenia has recorded sharp increases in foreign currency lending in the years before the adaption of the euro in 2007. The motivation of many borrowers was the expectation of joining the Eurozone soon. Non-euro foreign currency loans play a minor role in Slovenia and have declined from 7% in 2007 to 5% in 2011.

Bulgaria and Romania are two countries in which foreign currency lending still increased since the onset of the financial crisis in 2007. Bulgaria has reached the highest share of foreign currency loans in 2011 with 64%, while Romania recorded the highest value in 2010 with 63%. In both countries, however, growth rates have declined since 2007.

Overall, it seems that the financial crisis has led to a slight slowdown of foreign currency lending in CEE EU. Still, in many countries the absolute share of foreign currency loans is very high and risk perceptions are low, posing a certain threat to the financial stability of countries with floating exchange rate systems and thus to spreading the euro's international role. The European Systemic Risk Board in 2011 issued a recommendation on lending in foreign currencies with the aim of having Member States with high levels of foreign currency lending to unhedged borrowers (and thus potential system risk) take defensive measures (ESRB 2011, 2013).

Following is a brief discussion of the development of non-performing loans in CEE EU (see Figure 3). Again, one has to distinguish two time periods: pre-crisis (2001-2006) and crisis (2007-2011).

In the pre-crisis period, several countries showed relatively low levels of NPLs, namely Bulgaria, Estonia, Hungary, Latvia, Lithuania and Slovenia. Romania showed a mixed picture, with relatively higher shares NPLs in 2003 and 2004 and decreasing thereafter. The Czech Republic, Poland and Romania recorded significantly higher ratios of NPLs in the first two to three years, with declining trends until the onset of the financial crisis.

Since the onset of the financial crisis, NPLs have increased in all CEE EU countries significantly from 2006 pre-crisis levels. In absolute numbers, the highest shares of NPLs have been reached in 2010 by Latvia (19%) and Lithuania (20%). NPLs reached record highs in 2011 in Hungary (10%), Bulgaria (14%), Romania (13%), Slovakia (6%) and Slovenia (12%). Levels below 10% have been recorded in 2011 in the Czech Republic (6%), Estonia (5%), Poland (8%) and Slovakia (6%).

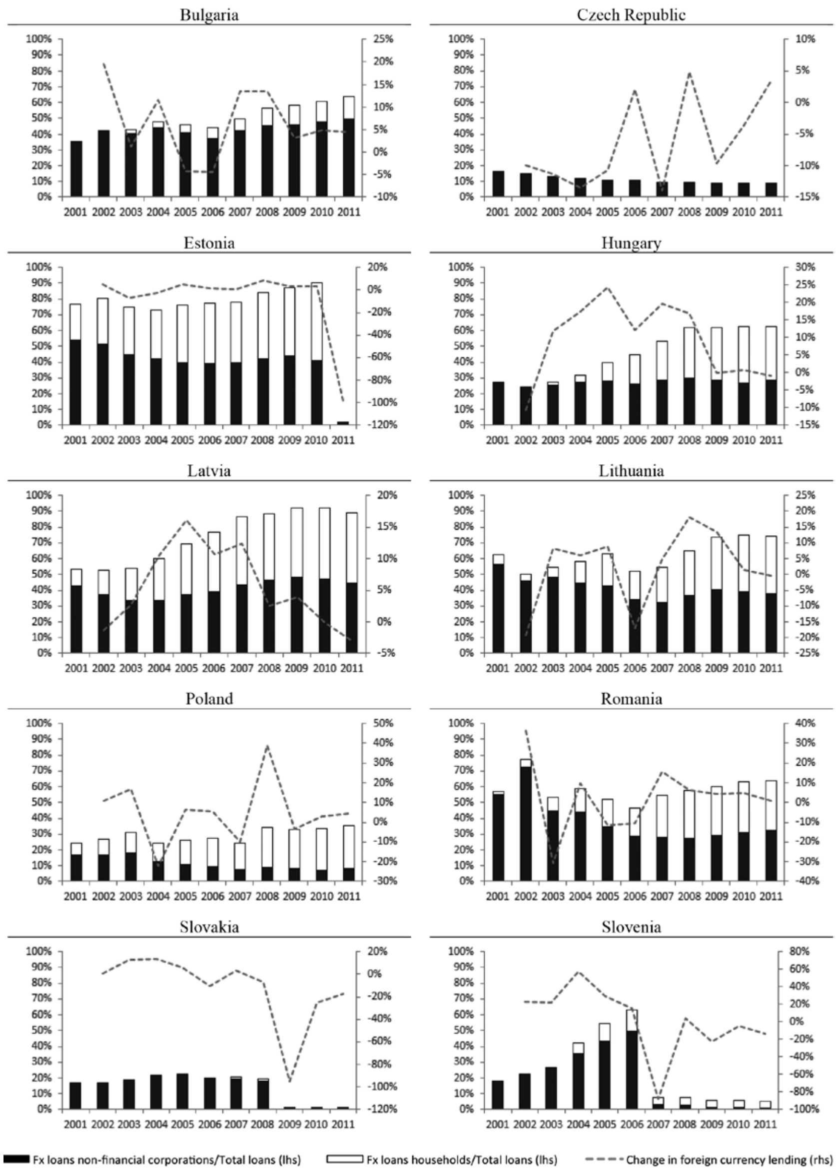

Figure 2 – Foreign currency loans in CEE EU.

Since 2007, NPLs have peaked only in half of the CEE EU countries (the Czech Republic, Estonia, Latvia, Lithuania and Poland). The other half recorded in 2011 the highest levels since the start of the crisis. However, growth of NPLs has slowed in all countries since 2009, with the notable exception of Slovenia.

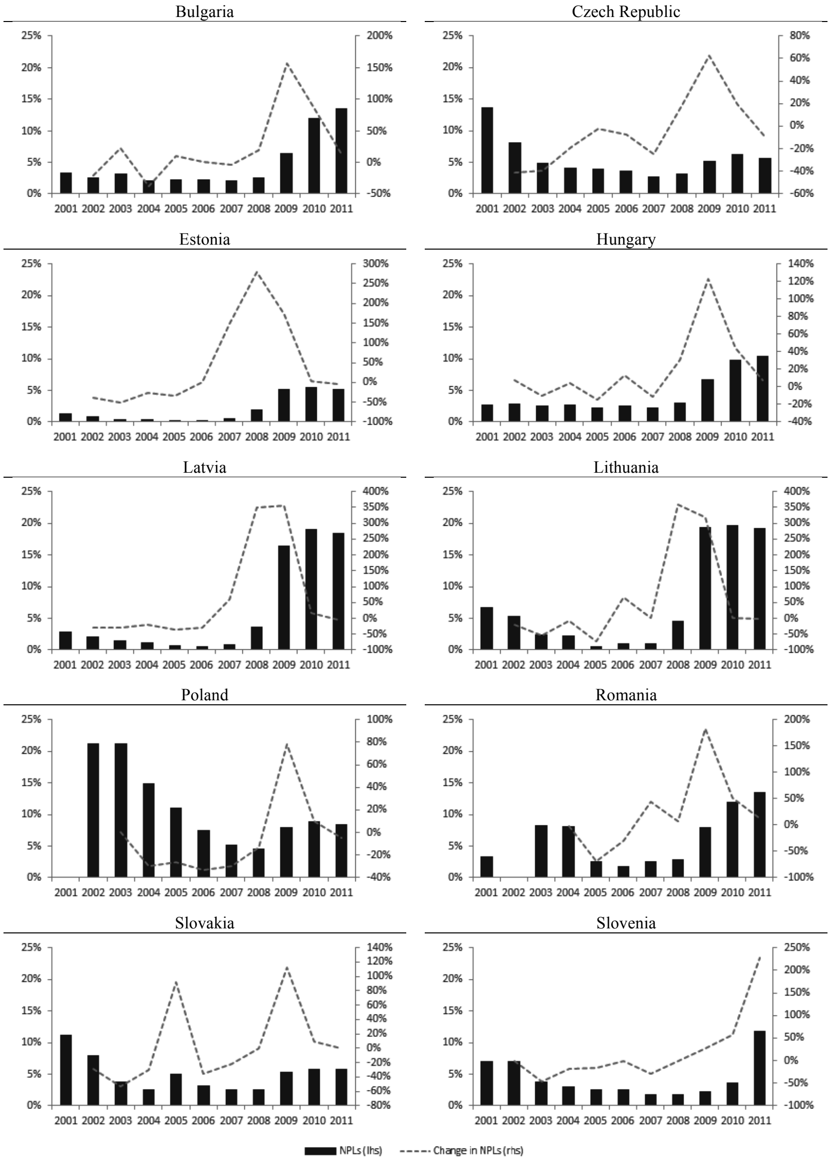

Figure 3 – Non-performing loans in CEE EU.

In total, the picture is that NPLs have increased considerably in all countries since the onset of the crisis in 2007, but there are signs that the increases have slowed and levels peaked in about half of the countries. In absolute terms, however, NPL ratios remain above 10% in six out of the ten countries, leading to serious concerns about the impact of this situation on the future development.

3. Literature review on the determinants of NPLs

Research on the determinants of credit risk has focused on three types of variables: macroeconomic, microeconomic (i.e. bank-specific variables) and (institutional) environment variables. Bank-specific variables include e.g. profitability measures, loan loss provisions, capitalization and foreign ownership (Boudriga *et al.* 2009), bank size, capital ratio and market power (Salas, Saurina 2002), asset growth, operating efficiency, and exposure to local loans (Bercoff *et al.* 2002) and industry concentration (Jiménez, Saurina 2006). One of the most studied bank-specific variables is abnormal loan growth (Cottarelli *et al.* 2005; Haiss, Ziegler 2011). Using bank-level data on 16,000 individual banks during the period 1997-2007 Foos *et al.* (2010) show that abnormal loan growth is an important determinant of the riskiness of banks as measured amongst others by loss loan provisions. Espinoza and Prasad (2010) find a strong positive relationship between loan growth and non-performing loans in the Gulf Cooperation Council (GCC) countries over the period 1995-2008. Jiménez and Saurina (2006) find a positive but lagged relationship between rapid credit growth and non-performing loans of banks.

With regards to (institutional) environment variables Boudriga *et al.* (2009) show that lower NPL ratios are associated with lower corruption, better regulatory quality, better enforcement of law and free voice and accountability. Pesola (2001) finds that the relatively better performance of Denmark during the Nordic banking crisis in the 1990s can be traced back to the earlier and smoother financial deregulation, although the direct measure of a deregulation dummy did not produce significant results. Using the VIX index (a measure of the implied volatility of S&P500 index options) as a proxy for global risk aversion and tight financing conditions and data on the GCC countries for the period 1995-2008, Espinoza and Prasad (2010) find that NPL ratios increase with increases in global risk aversion.

The impact of macroeconomic conditions on the profitability of banks (and thus also NPLs) has received quite some attention in the last decades, both from researchers and institutions. Stress tests are e.g. being performed regularly by financial supervisory authorities. The interest is mainly driven by the desire to understand the impact of macroeconomic shocks on the banking sector, in order to tailor policies that secure the soundness of the financial sector. Following is a discussion of the main macroeconomic variables that have been found to impact credit risk (measured either as non-performing loans or banks' credit loss provisions).

'GDP growth' has been shown to be the main determinant of NPLs in a number of studies. The rationale is that NPLs change with the stage of the business cycle. Quagliariello (2007) outlines that during expansionary phases the increase in aggregate demand leads to a strong and often abnormal growth in bank lending, fostered by underestimation of risks and relaxation of credit standards. After the peak, creditworthiness of borrowers decreases and non-performing loans increase. The situation can be aggravated by falling asset prices and increasing unemployment rates. Generally, studies find a negative relationship between GDP growth and non-performing loans, over different time periods and different country samples (e.g. Beck *et al.* 2013; Quagliariello 2007; Espinoza, Prasad 2010; Nkusu 2011; Fernández de Lis *et al.* 2000; Pesola 2001; IMF 2006; Bikker, Hu 2001; Pain 2003; Arpa *et al.* 2001; ECB 2011; Jiménez, Saurina 2006; Salas, Saurina 2002; Klein 2013). In a study on the Indian public banking sector Ranjan and Dhal (2003) get mixed results with regards to the impact of GDP on non-performing assets, concluding that different borrowers and lenders may respond differently to macroeconomic and business cycle conditions. Using a different methodology of neural networks, Cifter *et al.* (2009) show that industrial production cycles affect sectoral credit default rates in Turkey over the period 2001-2007.

'Unemployment' is a second measure of the state of the economy commonly used in these studies. Unemployment generally decreases in expansionary phases and increases during recessions. Thus unemployment is expected to be positively related to NPLs, which several studies confirm (Nkusu 2011; Gambera 2000; IMF 2006; Bikker, Hu 2001; Louzis *et al.* 2012; Klein 2013).

'Rising asset prices', commonly measured as either housing prices or stock market prices, are expected to increase borrower's wealth and help them face unexpected adverse shocks and get better access to credit by boosting the value of the collateral (Nkusu 2011). Thus the expected relationship between asset prices and NPLs is negative. Looking at the period 1992-2004 the IMF (2006) finds that the quality of mortgage portfolios increased with real house prices in Spain. To the contrary, Arpa *et al.* (2001) find that risk provisions of Austrian banks in the 1990s rose when real estate prices rose. Quagliariello (2007) finds for a large panel of Italian banks over the period 1985-2002 that asset prices show a small long-run negative effect on loss loan provisions. Nkusu (2011) finds a significant negative relationship between both changes in house prices and changes in equity prices on non-performing loans in a sample of 26 advanced economies over the period 1998-2006. The ECB (2011) as well as Beck *et al.* (2013) find a significant negative impact of share prices on non-performing loans in a large sample of advanced economies.

The relationship between 'interest rates' and NPLs is straightforward. Increasing interest rates directly increase the burden on borrowers and are thus expected to be positively related to NPLs. The IMF (2006) shows that over the period 1992-2004 the quality of mortgage and consumer credit in Spain deteriorated during periods of higher interest rates. Similarly, Pain (2003) finds that nominal interest rates are positively related to banks' provision ratio in the UK over the period 1987-2000. A positive relationship has also been observed by Arpa *et al.* (2001), Pain (2003), Beck *et al.* (2013), Jiménez and Saurina (2006), Espinoza and Prasad (2010), ECB (2011), Louzis *et al.* (2012).

'Credit to the private sector/GDP' is used to proxy financial fragility. Pesola (2001) finds that higher indebtedness (measured as bank lending/GDP), combined with negative macroeconomic surprises, contributed to the banking crisis in Sweden, Norway and Finland of the 1990s. To the contrary, Nkusu (2011) finds that a negative shock to credit to the private sector causes the NPL ratio to increase. Looking at the current economic crisis, Kauko (2012) finds for a broad panel of 36 developed countries that rapid credit growth in the pre-crisis period 2000-2005 was only associated with increases in NPLs when combined with a current account deficit.

The relationship between "inflation" and credit risk is ambiguous. Bikker and Hu (2001) find a significant negative relationship between inflation and provisions for credit losses for a sample of 26 industrialized countries over the period 1979-1999. A negative relationship has also been found by Pain (2003) and Bikker and Hu (2001). Arpa *et al.* (2001) and Klein (2013), on the other hand, find a positive relationship.

The exchange rate can have ambiguous impacts on non-performing loans. On the one hand, a depreciating local currency helps exporters as their goods become cheaper on international markets. On the other hand, a weakening currency has negative impacts on unhedged foreign currency borrowers. The ECB (2011) finds a negative relationship between changes in the nominal effective exchange rate and non-performing loans in countries with significant foreign-currency lending, and a positive relationship in countries with relatively low foreign-currency lending. Klein (2013) finds that exchange rate depreciations against the euro contributed to higher NPLs in the CESEE region over the period 1998-2011. Beck *et al.* (2013) find a positive relationship between the nominal effective exchange rate and NPLs for countries with low international claims and a negative relationship for countries with high international claims.

Other variables tested include amongst others workers per household (IMF 2006), income per household (IMF 2006), world trade growth (Espinoza, Prasad 2010), current account deficit (Kauko 2012), export and import growth (Kauko 2012), central government debt/GDP (Louzis *et al.* 2012) and risk aversion (Klein 2013).

4. Model

The model presented in this paper aims to test the impact of foreign currency lending on NPLs in CEE EU Member States. The basic model can be specified as

$$NPL_{it} = NPL_{i,t-1\alpha} + Y^{it}\beta + u_i + \varepsilon_{it}$$

Where *NPL* is the share of non-performing loans in total bank loans, *Y* is a vector of macroeconomic variables (some of which are also included as lags), *u* covers the individual unobservable effects and ε is the error term. Based on the review of the most tested macroeconomic determinants of NPLs we selected the following macroeconomic variables: Real GDP growth (RGDP); Inflation (INFL); Lending rate (LR); Nominal effective exchange rate (NEER);

Unemployment (UNEMPL); Change in stock market index (STOCK); Share of foreign currency-loans to the private non-financial sector (FXL); Share of foreign currency loans to non-financial corporations (FXL_C); Share of foreign currency loans to non-financial households (FXL_H).

Additionally, and as an alternative to the stock variables FXL, FXL_C and FXL_H we include two variables FXL_C_PRE and FXL_H_PRE that measure the average pre-crisis (2001-2006) share of foreign currency loans to non-financial corporations and households, respectively. We expect NPLs to be higher in countries with a higher share of foreign-currency loans in the years before the crisis. Due to data limitations, no such sectoral split was possible for NPLs.

5. Data and methodology

The sample covers annual data of the ten CEE EU countries (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia) for the time period 2001 to 2011[1]. Our data sample thus covers two time periods, pre crisis (2001-2006) and crisis (2007-2011). Data sources are the National Banks of the individual countries, the IMF, the EIU Country Data and Eurostat. Table 4 in the appendix contains variable descriptions and data sources. The following Table 1 contains descriptive statistics on the individual variables. Annual recordings for ten countries result in 110 observations per variable, with the exception of NPL (108), LR (108) and STOCK (106) because of missing values. The panel is therefore unbalanced.

Table 1 – Summary statistics.

	Observations	Mean	Standard Deviation	Min	Max
NPL	108	5.62	5.14	0.20	21.20
FXL	110	43.99	25.90	0.65	92.17
FXL_C	110	48.28	26.08	1.26	94.31
FXL_H	110	34.68	29.12	0.02	90.47
FXL_C_PRE	110	48.53	18.84	19.18	80.54
FXL_H_PRE	110	27.74	23.06	0.73	70.78
RGDP	110	3.74	4.97	-17.73	11.15
INFL	110	4.97	4.51	-1.08	34.47
LR	108	9.34	5.78	2.91	45.40
NEER	110	102.12	9.41	86.53	138.38
UNEMPL	110	10.24	3.89	4.10	19.92
STOCK	106	17.26	35.97	-62.68	124.14

[1] Croatia, though joining EU in mid-2013, had to be left aside for data availability issues.

The correlation matrix (Table 2) reveals that the independent variables are not highly correlated, with the exception of the lending rate (LR) and inflation (INFL). Because of this high correlation, we opt to include only LR in the investigation. The high correlation between FXL, FXL_C, FXL_H, FXL_C_PRE and FXL_H_PRE is obvious and these variables are not simultaneously incorporated as independent variables. FXL_C_PRE and FXL_H_PRE are derived from FXL_C and FXL_H measuring the average pre-crisis (2001-2006) level of foreign currency loans in a country. These variables are constant over time.

NPL is measured as bank nonperforming loans to total gross loans. There exist some problems with this variable because of cross-country differences in accounting rules and regulations. A detailed discussion of this problem goes beyond the scope of this paper. An in-depth analysis of different NPL classification systems in Central, Eastern and Southeastern Europe (CESEE) can be found in Barisitz (2011) or EBCI (2012).

Table 2 – Correlation matrix.

	NPL	FXL	FXL_C	FXL_H	RGDP	INFL	LR	NEER	UNEMPL	STOCK
NPL	1.00									
FXL	0.06	1.00								
FXL_C	0.01	0.97	1.00							
FXL_H	0.13	0.90	0.79	1.00						
RGDP	−0.42	−0.08	−0.05	−0.16	1.00					
INFL	−0.18	0.22	0.24	0.04	0.10	1.00				
LR	0.08	0.24	0.26	0.05	−0.08	0.81	1.00			
NEER	−0.18	−0.24	−0.22	−0.25	0.00	0.15	0.10	1.00		
UNEMPL	0.54	−0.13	−0.15	−0.14	−0.13	−0.30	−0.13	−0.09	1.00	
STOCK	−0.16	0.04	0.09	−0.07	0.55	0.00	0.03	−0.15	0.13	1.00

6. Summary and results

We analyze whether the high share of non-performing loans (NPL) in the EU CEE countries was, among others, driven by foreign currency (FX) lending which thus may have hampered economic development and convergence. This link between NPL and FX-lending has not yet received ample attention. We started out with simple OLS regressions with White standard errors and tested for the impact of the variables FXL_H_PRE (Model 1) and FXL_C_PRE (Model 2) which record the average level of foreign currency loans in the pre-crisis period 2001-2006. In a second step, we also performed cross-sectional panel data regressions. For Model 3 and 4, which include the variables FXL_H_PRE and FXL_C_PRE we opted for random effects, since these variables are time-invariant. As an alternative to the average pre-crisis level of foreign currency loans we also tested for the impact of the whole time series of the share of foreign currency loans on NPLs. Therefore we ran Models 5-7, which test for FXL, FXL_C and FXL_H, respectively. For these Models the Hausman test also suggested using random effects.

Similar to previous research, we find a strong negative impact of real GDP growth on NPLs across all Models. A rise in real GDP translates into a decline in the ratio of non-performing loans in total loans, underpinning the counter-cyclical behaviour of NPLs.

The autocorrelative nature of NPLs can be seen by the significant positive first-order autocorrelation of NPLs in all Models. Again, this is in line with past research.

With regard to the impact of foreign currency lending on NPLs, we find a positive relationship in all Models. Both the average variables (Models 1-4), as well as the stock variables (Models 5-7), produce significant results. With regard to hypotheses 1 and 2, these results show that higher shares of foreign currency loans in CEE EU countries over the investigated period are associated with higher non-performing loan ratios. This confirms the finding of Chitu (2012) that euroization was an important contributor to the severity of the crisis and thus hampered economic convergence.

The results do not show a significantly different impact of foreign currency lending to household or non-financial corporation on NPLs (Models 5-7). However, we do find a negative relationship between the nominal effective exchange rate and NPLs in 5 out of the 7 Models. This means that a depreciation of the local currency (lower value of the NEER) is associated with a higher share of NPLs. This finding is supportive of the theory that the exchange rate impacts NPLs via (unhedged) foreign currency borrowers and not via the export channel. A significant depreciation of the local currency increases the debt burden of unhedged foreign currency borrowers, which in turn increases NPLs. In combination with the findings above, this points to the important role of foreign currency loans as determinants of NPLs in crisis situations.

With regard to the other macroeconomic variables, we do not find a significant impact of unemployment, stock price development and the lending rate on NPLs in the sample under investigation.

7. Conclusions

Granting loans in foreign currency in CEE EU was driven by strong convergence optimism by investors and the banks competing for clients, as

Table 3 – Results [dependent variable: NPL – non-performing loans].

	Simple OLS, robust standard errors		Random effects GLS, robust standard errors				
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
NPL (–1)	0.846 ***	0.869 ***	0.792 ***	0.856 ***	0.857 ***	0.845 ***	0.854 ***
	(19.430)	(21.480)	(13.620)	(20.660)	(22.010)	(20.630)	(22.350)
RGDP	−0.385 ***	−0.384 ***	−0.355 ***	−0.388 ***	−0.367 ***	−0.361 ***	−0.375 ***
	(−5.060)	(−5.050)	(−4.170)	(−5.250)	(−5.220)	(−5.160)	(−5.240)
RGDP (–1)			−0.091				
			(−1.610)				
NEER	−0.080 **	−0.070 *	−0.073 **	−0.071 *			−0.069 *
	(−2.150) **	(−1.750)	(−1.990)	(−1.760)			(−1.830)
NEER (–1)	0.101	0.101 **	0.088 **	0.099 **	0.052 ***	0.044 **	0.107 ***
	(2.330)	(2.280)	(2.140)	(2.220)	(2.280)	(2.030)	(2.600)
FXL_H_PRE	0.014		0.013				
	(1.530)		(1.270)				
FXL_C_PRE		0.026 **		0.025 *			
		(2.190)		(1.720)			
FXL					0.027 ***		
					(2.840)		
FXL_H						0.024 ***	
						(3.150)	
FXL_C							0.022 **
							(2.070)
Constant	0.098	−1.974	1.193	−1.450	−4.001	−2.915	−2.462
	(0.050)	(−0.860)	(0.570)	(−0.580)	(−1.500)	(−1.160)	(−0.920)
Number of observations	97	97	97	97	97	97	97
R2	0.8499	0.8539	0.8544	0.8538	0.8556	0.855	0.8579

well as by borrowers, politicians and regulators. This business model did not go as planned and showed unintended effects: individually rational actions created a collectively damaging, systemic risk (Szpunar, Głogowski 2012). In this paper, we argue that the increase in NPLs since 2007 in many CEEEU countries was to a significant degree driven by foreign currency (FX) lending. Local currencies depreciated significantly since the onset of the crisis, leading to increases in the debt burden of unhedged foreign currency borrowers and subsequently higher NPLs. The results suggest that foreign currency lending is indeed associated with higher shares of NPLs in crisis situations. The findings give rise to the following discussion points:

(1) The widespread use of foreign currency loans increases the risk in crisis situations and can have negative cyclical effects via the feedback mechanism of NPLs on GDP growth. In the case of CEEEU, when Eurozone accession seems unlikely within the foreseeable future, one should discuss how to mitigate the negative effects of internationalization of the euro via the lending channel.

(2) Joining EMU respectively enlarging the Eurozone and its global appeal might be delayed by premature euro-denominated, large scale lending outside the Eurozone. Regulators might consider policies depending on the closeness to EMU entry, e.g. linked to participation in the ERM.

(3) We suggest that designing policies to curtail the use of foreign currency loans to unhedged households could be one such measure to increase financial stability via lower NPLs particularly when EMU entry is still further out. Loan-to-deposit ratios, FX reserve requirements, or currency-dependent loan-to-value ratios may be among possible solutions. Concerted regulatory efforts like the ESRB's (2011) recommendation to establish best practices in terms of foreign currency lending to unhedged borrowers which highlight the need for an orderly, non-disruptive cleanup process as also recommended by Klein (2012) are most helpful in this matter. The case of Hungary, where the government unilaterally introduced a 'fixed' exchange rate allowing customers to refinance their existing foreign currency loans at this favourable rate at the expense of the (mostly EU) banks, shows that there is need for a common procedure on how to deal with household foreign currency loans in crisis situations.

(4) Investigations on whether the speed (growth rate) of aggregate lending is healthy and supporting economic growth should also pay attention to the currency mix of loans granted. For example, the benchmark used by Cottarelli *et al.* (2005) is derived with the assumption of domestic currency lending. In the light of our findings with regard to the impact of foreign currency lending on NPLs, these studies results may need further interpretation and adjustment by including foreign currency issues. This equally applies to analyzing country risk in countries prone to foreign currency lending.

Appendix

Table 4 – Variable description and data sources.

	Description	Source
NPL	Bank nonperforming loans to total gross loans (%)	IMF, Global Financial Stability Report
FXL	Foreign currency loans to total loans to the private non-financial sector (%) (households + non-financial corporations)	National central banks
FXL_C	Foreign currency loans to total loans to non-financial corporations (%)	National central banks
FXL_H	Foreign currency loans to total loans to households (%)	National central banks
FXL_C_PRE	Average share of foreign currency loans to total loans to non-financial corporations (%) for the pre-crisis period 2001-2011	National central banks, Own calculations
FXL_H_PRE	Average share of foreign currency loans to total loans to households (%) for the pre-crisis period 2001-2011	National central banks, Own calculations
RGDP	Percentage change in real GDP, over previous year	EIU country data
INFL	Inflation: Percentage change in consumer price index in local currency (period average), over previous year	EIU country data
LR	Lending interest rate	EIU country data
NEER	Nominal effectice exchange rate against EU27 countries (2005=100)	Eurostat
UNEMPL	Recorded official unemployment as a percentage of total labour force	EIU country data
STOCK	Percentage change in stock market index (2005=100), over previous year	Eurostat

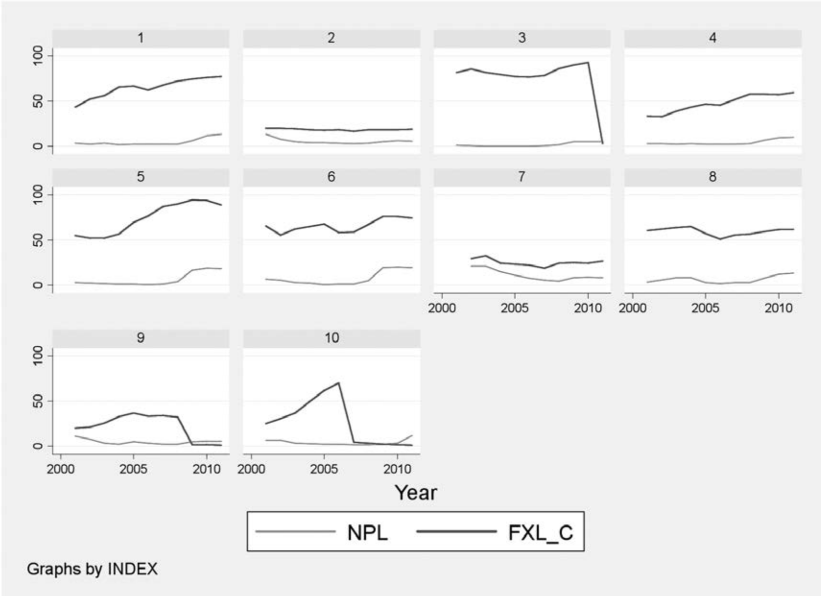

Figure 4 – Line plots of FXL_C and FXL_H vs. NPL.

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Conclusions

Rossella Bardazzi

The global financial crisis has caused a one-off reduction of income in all major economies. At present, the global economy is weak and recovery is slow and unevenly spread among the countries. In Europe this crisis is financial, economic and social. But it is also a crisis of confidence. The roots of the crisis are well known: Europe has not met the challenges of competitiveness; some Member States have lived beyond their means; imbalances between EU Member States have grown, particularly in the euro area. The deterioration in public finances has been a consequence of the global financial crisis and the related reduction of income but also, to some extent, the result of policies dating to the pre-crisis period. Of course, not all economies were affected in the same way. Some were better prepared for the shock or had structures that allowed them to resist at less cost. Sovereign debt concerns and uncertainty about the implementation of policy measures to combat the deterioration of government budgets have affected business and consumer confidence. The resulting fiscal consolidation efforts in some Member States still weigh on domestic demand and, combined with a slowdown in external demand, generate a subdued outlook for the EU economy. The European sovereign debt crisis has called into question not only the role and viability of States but also the achievements in European political and economic integration over many decades.

The process of European integration has developed through a gradualist approach in the expectation that further integration would be achieved along the way, not only induced by the opportunities offered within the new European framework but also forged by crises, as in the often quoted words of Jean Monnet[1]. European integration evolved between intergovernmen-

[1] «Europe will be forged in crises, and it will be the sum of the solutions adopted for those crises» (Monnet 1978). Along the same lines, the former President of the European Commission Romano Prodi argued (2001): «I am sure the euro will oblige

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talism and functionalism, but recent events show that both approaches fail to deliver a deeper union. On the one hand, intergovernmentalism, or any other more *ad hoc* form of co-operation among EU countries, does not function adequately over time. On the other hand, the 'chain reaction' implied by the functionalist perspective has fostered integration mainly in areas where heterogeneity costs were lower, while national governments have maintained their own sovereignty in areas where populations have different preferences, culture and identities[2]. The EU has always been both: the European institutions and the founding Member States. Both are expected to pursue their interests and mandates but ought to play their roles within a constructive framework. More specifically, European institutions are expected to act as sufficient counterweight to the Member States' particular interests. The recent economic and political difficulties across the continent have further strained and partly broken this balance within the Union, which has been sliding back into a loose intergovernmental structure. Nevertheless, the long experience in building the European Union and the euro area has demonstrated that progress can appear quite bumpy or dialectic. For instance, the 1992-1993 crisis of the Exchange Rate Mechanism caused its swift breakdown and led to a looser successor instrument, the so-called ERM-II with much wider fluctuation bands. However, in parallel and apparently paradoxically, it was this very crisis that gave impetus to the project of the single currency.

At present, the resurgence of national interests and intergovernmental decision-making has not exactly made crisis management at European level easier.

This book is a contribution to the debate about how European integration developed and what could happen next. All the chapters shed light on different aspects of the main features and problems of the European Union as well as on possible solutions. The euro area appears as a work in progress, an economic, political and social 'laboratory' where theories are tested and *a priori* expectations are either confirmed or refuted. From an economist perspective, since the beginning of the EMU the academic debate stressed the Optimal Currency Area (OCA) theory which underscored the fact that the Eurozone was not optimal, although it was argued that OCA requirements could be endogenously met through increased trade integration and more synchronized business cycles. Economic EU integration literature is also the perfect field for demonstrating the existence of trade-offs, the so-called 'impossible trinities' or 'trilemmas', since Mundell's first model of the open economy. Nevertheless, the debate on the future development of the

us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created» («Financial Times», 4 December).

2 For a discussion of this issue see Spolaore 2013.

European Economic and Monetary Union needs to be set within a broader context. Indeed a general review of economic policy and institutions is evolving at global level in the aftermath of the financial and economic crisis[3]. To synthesize our view of the current situation in the EU we could paraphrase the words of Olivier Blanchard, arguing that there is both progress and confusion (Blanchard 2015). The progress is undeniable, with reforms undertaken in recent years to create new institutions and strengthen existing procedures and surveillance mechanisms. Conversely, confusion is inevitable given the complex issues that remain to be resolved, which are also addressed in the contributions to this volume.

The EMU is slowly emerging from the recent year's turmoil very much changed and not for the worse, although better outcomes could be achieved. There is a widespread view that in some peripheral European countries the common currency is becoming more of a straitjacket than an opportunity for growth and convergence. The benefits of the single market are now taken for granted and it is often argued that convergence in living standards is no longer being delivered. It is widely agreed that since the creation of the European Union growth patterns have varied greatly between countries, being mainly influenced by competitiveness. It is frequently claimed that, in addition to the high levels of public debt, the problems of Southern Europe are caused by insufficient growth of productivity. Indeed competitiveness issues are often held responsible for the internal imbalances between Member States and for the ongoing debt crisis. Individual countries reveal distinctly different performances. The overall picture is that the non-tradable sector has been driving unit labour cost developments in Member States which have lost competitiveness compared to the euro area, while low wage developments in the tradable sector of Northern Europe have improved competitiveness. The European Monetary Union has caused a significant change in relative factor prices for many countries because wage developments have largely converged to the price stability objective of the European Central Bank. At the same time nominal interest rates have dropped, especially in Southern European countries, where the low credibility of previous monetary policy generated high risk premiums in financial markets. This effect is much less pronounced in the Northern Member States. In Germany, Finland, and the Netherlands, labour productivity, average capital efficiency and total factor productivity have largely evolved in synchrony. Thus, if competitiveness was gained or lost in these countries, it was due to wage developments. However, in Italy, France, Ireland, Portugal and Spain the deterioration of competitiveness has been strongly correlated with the reduction in capital efficiency since the monetary union started. In Italy, Spain and Portugal, and to a lesser extent

[3] See, as an example of this debate, the series of IMF conferences on *Rethinking Macro Policy.*

in France, labour productivity has effectively been stagnant for over a decade. The financial crisis acted as a trigger mechanism for structural imbalances accumulated in the first period of the EMU, with central European economies relying increasingly on tradable commodities and peripheral countries dominated by construction and non-tradable activities. International capital started to flow to finance these growing imbalances. However, the European Union has acknowledged that its economic policy framework has not taken into account the effects of diverging deteriorating price and cost conditions between some Member States and it has designed new policy procedures to deal with internal imbalances in the euro area. The so-called 'Six Pack' of governance measures was adopted by the European Council in November 2011 with the aim of strengthening economic governance and improving the competitiveness of European Member States, the latter in line with the instruments set forth in the Europe 2020 Strategy. Special emphasis is placed on measures to address macroeconomic imbalances through the new European Surveillance Procedure. European leaders agreed on a scoreboard for the surveillance of imbalances with a set of external and internal indicators such as current account balance, nominal unit labour costs, real effective exchange rates, house prices and the general government sector debt. Results now form the basis for the new alert mechanism (the Excessive Imbalance Procedure, EIP) being put in place by the Commission.

Another example of transformation to strengthen EU governance is the reform of the old Stability and Growth Pact (SGP). Since its adoption the SGP has been overstretched in opposite directions. It has been defined as 'stupid', asymmetric with respect to the economic cycle, too uniform across countries, not credible and lacking political ownership. Its interpretation and attempts at reform have swung between high flexibility (as in the 2005 revision) and stricter rules (as in the 2011 integration), to be mitigated again by the Commission communication of January 2015 introducing certain conditions for more flexibility depending on the cyclical situation, the adoption of structural reforms and investment projects co-financed by the EU.

This new framework of European economic governance is not exempt from criticism. The emended SGP continues to display some of its previous limitations, since it is still asymmetric and entails a difficult balance between the Council and the Commission. The new surveillance on macroeconomic indicators may prove difficult to implement, since some of the economic indicators are beyond the direct control of economic policy and some imbalances take a long time to be corrected.

Notwithstanding the progress in this path of improved economic governance, the EU has shown political and other limitations on its ability to perform effective crisis management. The main limitation is connected with the interaction between an integrated monetary area and fiscal prerogatives of Member States that are still highly decentralised. Despite such limitations, the EU has managed to adopt some landmark changes to its functioning and institutions in the midst of the unfolding crisis. In order to build a systemic response to a systemic crisis, a thorough overhaul of financial sector regulation has been designed and a new architecture of European supervision for banks, insurance and securities markets has been established with the emphasis on higher shock resilience and greater transparency. A Single Supervisory Mechanism, a Single Resolution Mechanism and harmonized deposit insurance schemes are the main building blocks of the Banking Union which is being finalised. It is conceived to address the 'financial trilemma' – financial stability, financial integration and national financial supervision can hardly be made fully compatible – and to contribute to break negative feedback loops between sovereigns and banks. If in a monetary union the financial system is to be genuinely single, a Financial Union is required, and the Banking Union needs to be followed by a Capital Markets Union (CMU). The recently-appointed European Commission has identified CMU as one of the main policy initiatives for its five-year term in office and a Green Paper on Capital Markets Union was published in February 2015. It should also be recalled that a European commitment to a single capital market now dates back nearly 60 years, since the founding fathers of the European Community considered a common capital market a prerequisite for a monetary system based on fixed exchange rates.

The path towards financial union started a long time ago, like those leading to economic and fiscal union, but all these issues are still high on the political agenda of the EU. Indeed they are highlighted as the main areas where progress is needed in the report of the Five Presidents of European institutions, *Completing Europe's Economic and Monetary Union*, published in June 2015. All central elements of European integration are tackled in this document with different nuances and emphasis. For instance, the last section of this report is implicitly devoted to political union, but there are only limited proposals for strengthening existing institutions and moving away from intergovernmental solutions (the preferential method during the crisis) towards a political system with increasingly shared sovereignty. It is stated in the introductory section that the euro area «will need to shift from a system of rules and guidelines for national economic policy-making to a system of further sovereignty sharing within common institutions». However, the proposed measures consist in strengthening Parliaments' involvement in the European semester and in setting up a euro area treasury. Clearly, the report focuses on financial and fiscal steps, while remaining rather vague on the political and institutional dimensions, which was also true of the 2012 Four Presidents' Report. This decision could be a sign of realism, in terms of the willingness to proceed towards a closer political integration. However, in the absence of political union, the economic governance of the Eurozone is based on a fragile alliance between market forces and rules of conduct that, moreover, have not always been respected. Certainly, the reforms cited above have begun the process of rebuilding confidence among Member States, but beyond financial and fiscal union there has to be the prospect of a political union. Indeed most of recent difficulties of the EMU are not technical or economic: they are primarily institutional problems to be solved by moving forward to a new sovereignty framework. In a 1991 paper (Padoa-Schioppa 2004: ch. 10) Tommaso Padoa-Schioppa stated that the European Community was *already* a political union because it dealt with political issues – related to the State or its government – and also in view of its institutional structure with legislative, executive and judiciary powers. However, at that time, a further development of a political union in the sense of subsidiarity and not of the Leviathan was explicitly expected, as shown in the preliminary works for the Delors Report. In an interview he gave at the beginning of the global crisis, he regretted to observe that the foreseen dangers of a 'currency without a State' had become true:

> It is clear that we needed more of a European State, not less of a European currency: without the euro, Europe would now be living a catastrophe. One reason for the lack of credibility of national politics is that it keeps on giving people the illusion that national powers are capable of tackling issues (energy, climate, finance, security, migration, primary goods) which are not national, but continental and global.

Member States resist sharing a sovereignty they have largely already lost. Instead they ought to try to recover it and transform the European Union into a global actor qualified to play on the worldwide stage.

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Abstracts

DESIGNING A NON-NATIONAL CURRENCY: THE EUROPEAN MONETARY UNION FROM THE EUROPEAN MONETARY SYSTEM TO THE EURO

Mauro Campus

The article argues that the economic governance of the Eurozone set up in the early 1990s derives from the compromise between French President Mitterrand and German Chancellor Kohl about the issue of German reunification, and was built in such a way as to satisfy the parameters imposed by the German economic model. The dominance of the D-Mark was inevitable, as soon as the common governance was implemented, and continued through the different stages that brought to the Economic and Monetary Union. The current crisis of the euro therefore derives directly from the structural setting adopted in Maastricht and implemented throughout the 1990s and the early 2000s. The essay offers a historical analysis of the events that brought from the crisis of the Bretton Woods system in the early 1970s to the different stages of monetary integration – the 'Snake' at the beginning of the decade, the European Monetary System in the late 1970s and the Economic and Monetary Union in the 1990s. A special focus is devoted to the political context in which these developments occurred, in particular for what concerns the issue of German reunification and the end of the Cold War. The core part of the article focuses on the political debate surrounding the Maastricht Treaty, with an analysis of its consequences on the economic structure of the euro area. In conclusion, an analysis of the current economic situation of the Eurozone and its developments is exposed.

JEL: F02, F33, F53, E42, E58.
Keywords: Economic Interdependence, European Monetary System, Maastricht Treaty, Economic and Monetary Union, Stability and Growth Pact, Eurozone.

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TIME TO RECONSIDER STATUS: THE IMF, THE EU, THE EURO AREA AND ITS SOVEREIGN DEBT CRISIS

Jan Wouters and Thomas Ramopoulos

The advent of the sovereign debt crisis in the euro area prompted a significant shift and deepening of the relationship between the European Union and the International Monetary Fund. The last years the Union and the Fund have been cooperating closely in providing financial assistance both to non-euro area and euro area Member States. Thereby, the Fund has become a major actor, if only temporarily, in European economic governance. However, at the same time neither the EU nor the euro area is a member of the IMF; they can only influence the latter's work indirectly, through their Member States who are IMF Member Countries. This paper discusses whether the close EU-IMF cooperation and the aforementioned enhanced role of the IMF in European economic governance can be a factor in favour of a more influential role of the EU/euro area in the Fund through the unification of its representation. First, the current status of the EU in the IMF is briefly described. Second, the role of the IMF in European economic governance before and after the crisis is revisited, as illustrated, among others, in financial assistance programmes within the EU and in EU legislation. The focus thereby lies in particular on developments after the advent of the crisis and the cooperation between the EU and the Fund in tackling financial problems both in non-euro area and euro area Member States. In addition, attention is paid to the influence of the IMF on the revamping of the European economic governance through, in particular, the establishment of robust crisis management mechanisms. The findings are that the Fund will continue to have some role in European economic governance, at least in the mid-term. It is therefore in the interest of the EU/euro area to strengthen its representation in, and impact on the work of, the IMF. The feasibility of this proposition is examined in light of the potential and limits of EU law.

JEL: E02, F33, F55, K22.
Keywords: EMU, European Economic Governance, Financial Assistance, IMF, EU/Euro Area Representation.

INTEGRATION WITHOUT CONVERGENCE IN THE EUROPEAN CURRENCY AREA

Elisabetta Croci Angelini and Francesco Farina

We set up the conceptual framework to understand why fifteen years after the switch to a single money the conditions for optimality of the European currency area have not been met. Our statistical computations show that a sluggish market adjustment after a shock, and the weak impact of fiscal stabilization policy on national GDP deviations from the EMU-average GDP, ended up in the failure of the Periphery to realize *per capita* income convergence to the Core. The financial integration following the monetary union fell short from creating the mutual risk-sharing that would have been needed to cope with asymmetric shocks hitting the EMU countries. The financial crisis induced the 're-nationalization' of the public debt, thus increasing the degree of risk for both banking institutions and governments. Since the formation of a monetary union does not *per se* facilitate the participating countries in *ex post* compliance with the optimum currency area criteria, the institutional framework of the Eurozone macroeconomic governance has to become more comprehensive than the mere enforcement of tight surveillance and fiscal rules on national budgetary policies.

JEL: E42, E63, F15, F36, F43, H61.
Keywords: Economic Integration, Optimum Currency Areas, European Monetary Union.

THE EUROPEAN BANKING UNION: THE LAST BUILDING BLOCK TOWARDS A NEW EMU?

Fritz Breuss

In order to fix one of the missing problems of the euro area in times of a crisis, in 2014 the euro area started with a European Banking Union (EBU), at least with the first pillar, the European Bank Supervision with a Single Supervisory Mechanism (SSM) established at the ECB. The other necessary steps – the Single Resolution Mechanism (SRM) and the Single Deposit Guarantee Scheme (SDGS) – will follow later. A first evaluation indicates that the potential benefits of solving bank problems via the resolution mechanism of a new EBU would be distributed unequally between the Member States of the EU/euro area. Germany would be the biggest loser, Spain and the Netherlands are the biggest winners. Of the non-euro countries, the UK and Sweden have the most to gain, but Poland would lose. The country-specific gains of EBU depend on the number and size of banks which are located in a country. It is, however, not yet clear whether the goal of macroeconomic stabilizing of bank resolutions would be better achieved when executed via the SRM or with the ESM, both for the countries affected and for the euro area as a whole. First estimates indicate that a genuine EBU – by avoiding a systemic banking crisis – would result in macroeconomic net benefits for the EU in the range of 0.7% to 1% of annual GDP.

JEL: E42, E61, F15, F33, F41, F53.
Keywords: Economic and Monetary Union, Eurozone, European Integration, Banking Union.

MACROECONOMIC ADJUSTMENTS AND REFORMS IN THE EURO AREA

Christian Keuschnigg and Klaus Weyerstrass

When the euro was introduced, the exchange rate risk was eliminated, resulting in very low interest and in overly expansionary demand, price bubbles and increasing private indebtedness in the euro area periphery. International price competitiveness was eroded and large external imbalances built up. Furthermore, governments were confronted with low financing costs and easy access to credit, leading to high budget deficits and public debt. Meanwhile, macroeconomic reforms and adjustments in the crisis-struck countries of the euro area have resulted in improved international competitiveness and lower public deficits. At the same time, several new institutions were created on the European level which strengthened mutual economic surveillance and cooperation. In this paper we review the roots of the imbalances in the euro area and document the adjustments in the Member States as well as the institutional reforms on the European level. We conclude that the future of the euro area will be determined by continued national reform towards fiscal balance and increased competitiveness and growth, continued recapitalization of the banking sector, and the completion of the banking union with central regulation and oversight including bankruptcy rules for large banks.

JEL: E62, F15, F32, H63.
Keywords: Euro Area, Macroeconomic Adjustment, International Competitiveness, Banking Union.

EUROZONE CRISIS: POSSIBLE FUTURE SCENARIOS

Lubor Lacina

While some EU and Eurozone countries have managed to withstand the financial and economic crisis after 2008 successfully, other States are still up to their ears in problems, with yet others (including key players) expecting painful reforms in the name of fiscal policy recovery and greater competitiveness. Such steps, however, hurt many citizens, and if they arrive sanctified by Brussels, it is not difficult to start an avalanche of europhobia or euroscepticism. The European Union finds itself at a crossroads. The debate on its future direction and possible scenarios is the main objective of this chapter.

JEL: F34, F36, E65, H12, H63, H77.
Keywords: Eurozone, Common Currency, Economic Crisis, Grexit, New Eurozone Order, Europhobia.

THE EUROPEAN PARLIAMENT AND THE EUROPEAN COUNCIL: FUNCTIONS AND ROLES IN THE EUROZONE CRISIS MANAGEMENT. A POLITICAL AGENDA ANALYSIS

Elisa Cencig and Laura Sabani

The economic and financial crisis has had profound consequences not only for the economies of EU Member States, some of which are still far from complete recovery, but also for the architecture of the Economic and Monetary Union. This work aims to analyse the action of the European Council and the European Parliament in response to the economic and financial crisis. The theoretical approach underpinning this analysis is the policy agendas project, which dates back to Baumgartner and Jones' seminal work, appeared in the 1990s. The codebook developed by these scholars allows to study the actions of different institutions by applying a standardized content-coding procedure and hence facilitates comparison over time and across policy fields. The agenda setting approach was chosen as it represents an objective way to evaluate the policy areas the EUCO and the EP dedicated most of their attention to, as well as the specific issues in the encompassing area of economic and financial affairs. We analyse and compare the policy agendas of the European Council and the European Parliament over the period ranging from 2009 to spring 2014, which corresponds to the EP's 7th term. Our quantitative analysis is based on the European Council Conclusions database, directly derived from the pre-existent EU Policy Agendas dataset, with the addition of 2013 and 2014 meetings. The European Parliament Plenary Agendas database is entirely original and was compiled following the same content coding procedure used by scholars working on EU Policy Agendas. Our quantitative analysis shows that the European Council exercised a key agenda-setting function in leading the reform of the architecture of the Economic and Monetary Union. On the other hand, the European Parliament has been a pivotal actor in ensuring the adoption of all 'crisis-related' legislation, but it would be probably far-fetched to say that it acted as an agenda-setter in this field. In a nutshell, it might well be possible to conclude that the economic and financial crisis reinforced the role of the European Council, and contributed to its image as a powerful engine of European integration.

JEL: G01, D72, H12.
Keywords: Political Processes, Agenda Setting, Policy Agenda, European Council, European Parliament, European Union, Financial Crisis, Crisis Management.

BANKING ON THE EURO AS AN INTERNATIONAL CURRENCY: CONSEQUENCES FOR EAST-ASIAN CURRENCIES

Bernadette Andreosso-O'Callaghan

Recent financial crises (1997 and 2008) turned out to be opportunities for Asian economies in general and for China in particular. Our discussion on the rising importance of Asian financial markets highlights how the Chinese economy is being able to carve itself an increasingly important niche in these international markets. This leads to the question as to whether the euro will ever lose its chance to be an international currency to the benefit of the renminbi (RMB), a question that is tentatively explored in this chapter. The path towards the internationalization of the RMB is nevertheless fraught with some risks and leaves therefore different scenarios open. What is more certain is that at a time when the RMB has become East-Asia's and South-East-Asia's new reference currency, and *de facto* a global reserve currency, urgent reforms of the euro and of governance at the level of EU institutions have become an inescapable necessity.

JEL: F3, E5, G1.
Keywords: RMB, International Currency, Financial System, China.

GLOBAL CURRENCY-REGIONAL CURRENCY: THE INSTITUTIONAL STRUCTURE OF THE EMU AND THE LEGACY OF THE SOVEREIGN DEBT CRISIS

Antonia Calvo Hornero

After several long years searching for a greater monetary cohesion in Europe, the plan for an Economic and Monetary Union and an exclusively European common currency represented one of the greatest achievements, not only on a European level, but also on an international level following the end of the Bretton Woods system. The idea of the creation of a single currency not only caused uncertainty regarding economic and monetary issues, but also raised doubts about its future. Among the issues raised was the euro will become an international currency and displace the dollar or stay as a regional currency in the future? The international financial crisis affected all the countries in the EU from 2007 to 2009, but after May 2010 the crisis centered on the countries of the Eurozone, unleashing the sovereign debt crisis. The aim of this article is to highlight the rules governing a global currency and regional currency like the euro and the impact that the financial crisis and the sovereign debt crisis have had on the single currency, given the institutional structure and system governance with which it endowed the EMU.

JEL: F33, G01, N23.
Keywords: Euro, Global Currency, Regional Currency, Institutional Structure, Sovereign Debt, Governance.

THE EURO AS INTERNATIONAL CURRENCY: EURO-LOANS IN CENTRAL AND SOUTH-EAST EUROPEAN COUNTRIES

Gerhard Fink, Wolfgang Rainer and Peter R. Haiss

We compile data about euro denominated lending in Central, East and South-East European Countries (CESEEC) during 2001-2011. Our analysis of the determinants of non-performing loans with panel regressions for CESEECs suggests that foreign currency loans contributed significantly to the increase in non-performing loans, reinforced by effective changes in exchange rates, which cannot be sustained by the local borrowers. We find that there are serious limits to euro-globalization with euro denominated loans.

JEL: E44, E58, F31, G21, O11, O16, P34.
Keywords: Non-Performing Loans (NPL), Euro-Denominated Loans, Foreign Currency Lending, Foreign Banks, CEE EU Members.

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