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THE MUTATING EURO AREA CRISIS

IS THE BALANCE BETWEEN "SCEPTICS" AND "ADVOCATES" SHIFTING?

By Francesco Paolo Mongelli

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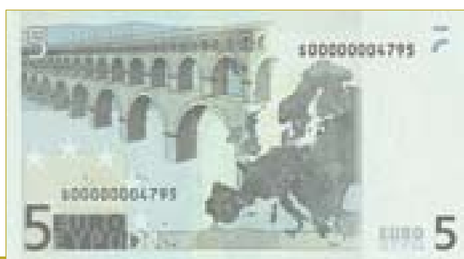

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ABSTRACT

The destructive potential of the sovereign debt crisis of the euro area has been slowly abating since last summer, but still remains considerable. One reason for it is the sheer complexity of the crisis, which brings together several harmful factors, some long-standing, others more recent, like acts of an ever-growing and mutating tragedy. It combines the features of a financial crisis in some countries with those of a balance-of-payment crisis or sluggish growth in another, overlapping group of countries. All these factors have struck Europe before, but never all at the same time, in so many countries sharing a currency, and with limited adjustment mechanisms. Some countries must undertake sizeable stock-flow adjustments, and reinvent parts of their economies. But the crisis also has two additional dimensions, one being flaws in the governance of the euro area, and the other being an erosion of trust in the viability of the euro area itself. Such concerns have led to talk of a "bailout union", a "permanent transfer union", or the hegemony of a country, the lack of solidarity or of risk-sharing, the lack of vision, the risks of fiscal or financial dominance, and so on. The aim of this paper is to give expression to some thoughts on the various dimensions of the crisis without claiming to offer a coherent and conclusive view either of the crisis or the future of the euro area. While the crisis is a traumatic wake-up call, it is also a catalyst for change. Understanding the reform efforts under way will help rebalancing the views of sceptics.

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Keywords: Economic and Monetary Union, Euro, Sovereign Crisis, Optimum Currency Area Theory, Governance Reform, Risk-Sharing, and Moral Hazard

EXECUTIVE SUMMARY

The sovereign debt crisis has been – and remains – a traumatic event in the still short history of the euro area. This paper shows that it cannot be interpreted as a unitary phenomenon: the crisis is a mix of several harmful factors that are distinct but interlinked. It has also mutated over time along a succession of phases. There were flaws in the design of Economic and Monetary Union (EMU) and the nature of the prevailing shocks has changed, becoming slow-moving, cumulative imbalances that are very difficult to handle in a monetary union. Some argue that responsibility for the crisis can be lain at various doors. Policy-makers, banks, households, firms and others can be faulted for their exuberance and misjudgement. Therefore, with hindsight responsibilities for the crisis are quite diffused, and incidentally most economists failed to see it coming too. Moreover, once the sovereign debt crisis had erupted, there was no crisis management framework and no financial backstop for either sovereigns or banks. The ensuing dysfunctional policy debate and the fractious national responses were also harmful. Understandably, national disaffection rose, as did scepticism about the euro area.

The aim of this paper is to articulate some thoughts on the various dimensions of the crisis without claiming to offer a coherent and conclusive view either of the crisis or the future of the euro area. The crisis is a catalyst for change, the full effects of which is slowly becoming apparent. Understanding the reform efforts under way will help rebalancing the views of both sceptics and advocates.

The "uniqueness of EMU"– i.e. a strong single market, a strong single currency, but a modest political union – originates from the choices and constraints that emerged in the 1950s. Back then, functional integration prevailed over the sharing of sovereignty and a true political union (of the type that is being discussed today). A bit later, there was too little understanding of what EMU's architecture – sketched in the 1992 Maastricht Treaty – can and cannot do, and what types of shock it might actually withstand after the launch of the euro. EMU scepticism came into being at the same time as the euro: several influential economists immediately doubted that EMU would ever work. These doubts have resurfaced and gained credence during the crisis.

The achievements during the first ten years of the euro are linked with the severity of the crisis. The reason is that the euro had both intended as well as unintended effects. There was a dichotomy. On the one hand, trade and financial links deepened, and cross-country investments (FDIs) rose. The Single Market expanded and the "home bias" declined. On the other hand, not all these benefits proved to be sustainable as they were predicated on cheap and abundant short-term funding channeled mostly by the banking system. The financial turmoil that started in August 2007 and the global financial crisis that erupted in October 2008 shattered cross-country money markets and triggered a process of "renationalisation". Cheap liquidity dried up, greatly contributing to the erosion of trust in the solidity of the financial system. Also the pre-EMU adjustment mechanism – national monetary and exchange rate policies were of course not available – broke down. What happened is that after the launch of the euro various imbalances grew unchecked in several euro area countries, including persistent budget deficits, rising current account deficits and feeble productivity growth. The global financial crisis and the recession of 2008-2009 were not the fault of the euro, but they exacerbated these imbalances.

In late 2009, the belief that euro area membership would act as a shield against exchange rate volatility and credit risks vanished with the start of the sovereign debt crisis in Greece. Deeper cross-country trade, credit flows and FDIs, as well as financial exposures became the "vehicles" of the sovereign debt crisis. The euro has accelerated a process of concentration and specialisation

which has far-reaching implications for the solution of the sovereign debt crisis: several countries are now much less diversified and require time to reinvent parts of their economies. While Greece was the trigger, in early 2010 concerns about the public finances and financial health of other euro area countries rose rapidly, one after another. There was contagion, and an adverse feedback loop between weakening sovereigns, fragile banks and shrinking economies set in, punctuated by ever lower credit ratings and weaker balance sheets. The flaws in EMU's design emerged. The euro area did not have a common crisis management and resolution framework. There were no backstops for sovereigns and banks. The crisis is now having severe effects on Greece, Ireland, Portugal and Spain, while Cyprus and Italy are also under financial pressure.

The responses to the crisis emerged in a series of EU and euro summits and joint decisions: there is now realism and an acceptance of the need for changes in governance and the strengthening of institutions. This will be a gradual process that has been supported by various unplanned "insurance mechanisms", which receive too little recognition and which have allowed the euro area to partly cushion the impact of the crisis, avoid financial meltdowns, and temper the contagion effects. As a result, a new "constitutional framework" is emerging and a new political economy is within reach, reducing future systemic risks.

The paper illustrates the effects of the euro area imbalances as well as the sovereign debt crisis using the optimum currency area (OCA) theory. This framework illustrates the need for more openness and economic and financial flexibility by each country. This will in turn raise their income correlation over time. Therefore, there is a dimension of the crisis that remains supremely national: finding a consensus on, and support for, new social contracts among national constituencies, and choosing sustainable national covenants that boost flexibility, openness and correlation. The euro area will become a different sort of viable optimum currency area than, for example, the US, but it will still be very beneficial for each euro area country.

Still, the path out of the crisis will be long and strewn with obstacles. Many commentators and pundits still fear that a break-up of the euro area is inevitable. Others are still concerned about a possible irreversible stagnation and even a financial meltdown in some countries (although such risks have partly receded since last summer). Fear and the will to survive are powerful motivators: they are certainly contributing to the radical reforms that we are witnessing. There is a challenge of transition, implementation and transposition (into national law). However, in the long-term, the integrity and prosperity of the euro area must be grounded on its intrinsic values, for example, as a catalyst for a stronger single market and deeper (and sound) economic and financial integration, and because of its long-term benefits.

In many ways, the factors that led to the launch of the euro are still valid, and the crisis we are in is not a monetary crisis. The euro can act as a shield against outside shocks, secure the benefits of a credible world currency and foster internal stability. A restored stability of the euro – include the fiscal compact and the four unions may ease the sharing of sovereignty that comes with the "new EMU". The balance between EMU sceptics and advocates may then slowly change. The rest will follow.

1 INTRODUCTION

"Break-up", "costly mistake": there is no shortage of negative views on the future of the euro area as a result of the sovereign debt crisis. Numerous commentators have been warning about the risks of prolonged stagnation and even a looming economic collapse in several euro area countries. And yet, over the last 24-36 months, there has been a remarkable response in terms of improved governance, a start of extensive economic reforms and new European institutions. There is an awareness of the risks that the euro area is still running and an acceptance of the need for profound structural changes. Confidence is now slowly coming back, but remains fragile. *What went wrong with European Economic and Monetary Union (EMU)? Was it the fault of the euro? How can the euro area be made viable?*

Several experts have attributed the severity of the sovereign debt crisis to the vicious feedback loop between its various dimensions, notably the worsening economic and financial imbalances inside the euro area, the flaws in the design of EMU and the increasing inadequacy of EMU's political economy, as well as the growing decline of trust in, and public support for, EMU. As confidence ebbed away, credit spreads rose in stressed countries, thus raising the cost of funding for already weak sovereigns and their domestic firms and banks. At the same time, it has been this escalation of the crisis and the risks of a meltdown over the last 24-36 months that has provided the impetus for domestic structural reforms and fiscal consolidation, not to mention agreement on new European institutions. A new political economy is now within reach.

Yet quick results are practically impossible. First, the transition to EMU's new political economy and towards the "four unions" – i.e., banking, economic, fiscal and political union – will take time (European Council (2012)). Second, national reforms need to be explained, accepted and implemented domestically: generally, two to three years pass before their benefits become apparent (as with Hartz IV in Germany). Third, it may take some time to reinvent large parts of the stressed economies: but a "new Greece" will emerge. This paper raises some points that are missing in today's heated debate on the sustainability of the euro area and the viability of its new political economy.

The aim of this paper is to give expression to some thoughts on the various dimensions of the crisis without claiming to offer a coherent and conclusive view either of the crisis or the future of the euro area. *How can we shift from short-term stabilisation and the current improvements in financing conditions and mood, to long-term viability along all dimensions of the crisis?* In several ways, now a long-term vision is needed to anchor expectations and guide the adjustment process (Gaspar (2013)). But, perhaps the biggest challenge is that within the "euro area story" there are the "national stories". In fact, there is a dimension of crisis-resolution that remains supremely national: namely, finding a consensus on, and support for, new social contracts among national constituencies, and choosing sustainable national covenants. The euro, and EMU's new political economy, can support such national transitions, foster a virtuous feedback loop, and promote the seeds of such a long-term vision.

The paper is organised as follows. In **Section 2**, European integration is "deconstructed" into the three main forces that have shaped it over time: i.e. political, economic and monetary integration. These forces have not always been aligned, and over the last 60 years there have been synergies but also tensions between them. The choices made many decades ago still have repercussions today. While the Single Market – i.e. economic and monetary integration – and monetary arrangements have advanced steadily, only a limited amount of national sovereignty has been shared. Hence, all

along there was only a modest degree of genuine political union, of the type being discussed today. With hindsight, following the launch of the euro a much stronger political economy would have been needed in order to compensate for the loss of national exchange rates as disciplinary devices (and also as adjustment mechanisms). Therefore, systemic risks were in part endogenous to the original EMU's architecture. A strand of EMU scepticism came into being at the same time as the euro: several influential economists immediately doubted that EMU would ever work. These doubts resurfaced and grew during the crisis.

Section 3 presents a brief review of some of the intended as well as unintended effects of the euro in its first decade. There was a dichotomy. On the one hand, trade and financial links deepened, and cross-country investments (FDIs) rose. The Single Market expanded and the "home bias" declined. On the other hand, not all these benefits proved to be sustainable, as they were predicated on cheap and abundant short-term funding. In August 2007, the financial turmoil and the global financial crisis that erupted in October 2008 shattered cross-country money markets and initiated a process of renationalisation. Cheap liquidity dried up, greatly contributing to the erosion of trust in the whole financial system. Also the pre-EMU adjustment mechanism – national monetary and exchange rate policies – was of course not available. After the launch of the euro various imbalances grew unchecked in several euro area countries, taking the form of persistent budget deficits, growing current account deficits and feeble productivity growth. The global financial crisis and the ensuing recession of 2008-2009 were not the fault of the euro, but exacerbated these imbalances. In late 2009, the conviction that euro area membership would provide a shield against exchange rate volatility and credit risks vanished with the start of the sovereign debt crisis in Greece. A less discussed phenomenon is that the euro might have accelerated in some countries a process of specialisation which has far-reaching implications for the sovereign debt crisis (the "*EMU's elephant in the room*").

Section 4 argues that while Greece was the spark, concerns about the public finances and financial health of other euro area countries then rose rapidly, one after another. There was contagion, and an adverse feedback loop between weakening sovereigns, fragile banks and shrinking economies set in, punctuated by ever lower credit ratings and weaker balance sheets (Eijffinger (2012)). Flaws in EMU's design emerged. The euro area did not yet have a crisis management and resolution framework. There were no backstops for sovereigns and banks (*no firewalls and no fire brigade*).

Section 5 lists the responses to the crisis that emerged from a series of EU and euro area summits and joint decisions. There is now a more realistic approach and an acceptance of the need for changes in governance and the strengthening of institutions. This will be a gradual process that was supported by various unplanned "insurance mechanisms" which receive too little recognition and which have allowed the euro area to act as a buffer against the crisis and temper the contagion effects. As a result, a new "constitutional framework" is emerging and a new political economy is within reach, thus reducing future systemic risks.

Section 6 illustrates the effects of the euro area imbalances, as well as the sovereign debt crisis by using the optimum currency area (OCA) theory. There is a need for more openness and economic and financial flexibility by each country. This will in turn raise their income correlation over time. Because of the functional process of integration, the sustainability of the euro area in the long term hinges on three parameters: flexibility, openness and correlation. Therefore, there is a dimension of the crisis that remains supremely national: finding a consensus on, and support for, new social contracts among national constituencies, and choosing sustainable national covenants that boost flexibility, openness and correlation (with partner countries). The euro area will become a different

sort of viable optimum currency area than, for example, the US, but still be beneficial for each euro area country.

In **Section 7**, two contrasting scenarios about the future of the euro area are presented: the first is a "virtuous scenario" involving a gradual transformation of the euro area, while the second scenario entails multiple equilibria with possible self-fulfilling prophecies which erode confidence and reignite the adverse feedback loop between sovereigns, banks and the economy. Some final points are in **Section 8**.

Scepticism and advocacy are not binary variables: there are many graduations in between. Different people may have different views on the factors contributing to the crisis, the remedies to the various dimensions of the crisis and the policy responses to the crisis itself. Wherever possible we refer to constructive criticisms. As the situation is still evolving and the crisis is not over, various caveats apply. Above all, there should be no relapses. "There are signs of convalescence and "re-integration" in European financial markets" (Cœuré (2013)), or as recently put by Mrs. Lagarde: "We stopped the collapse, we should avoid the relapse, and it's not time to relax."

2 THE RUN-UP TO EMU: THREE FORCES AND... AN OMISSION

Choices made 60 years ago still matter today

The euro area has been shaped by three main forces: political integration, economic integration and monetary integration. **Political integration,** i.e. the desire to pull together countries that had been at odds and even at war in the past, provided the initial impulse for European integration. After the French National Assembly turned down plans for a European Defense Community in 1954 – a step that was encouraged by Winston Churchill – Europe chose instead a process of "functional integration", i.e. pursuing integration in various incremental – and feasible – steps (Chart 1). Since the 1953 European Steel and Coal Community (ECSC) and the 1957 Treaty of Rome, we have seen the creation of a free trade area, a customs union, a common market (for goods, services, capital and people), and increasing coordination of national economic policies and the harmonisation of relevant domestic laws to avoid protectionism.[1]

European integration has an engine

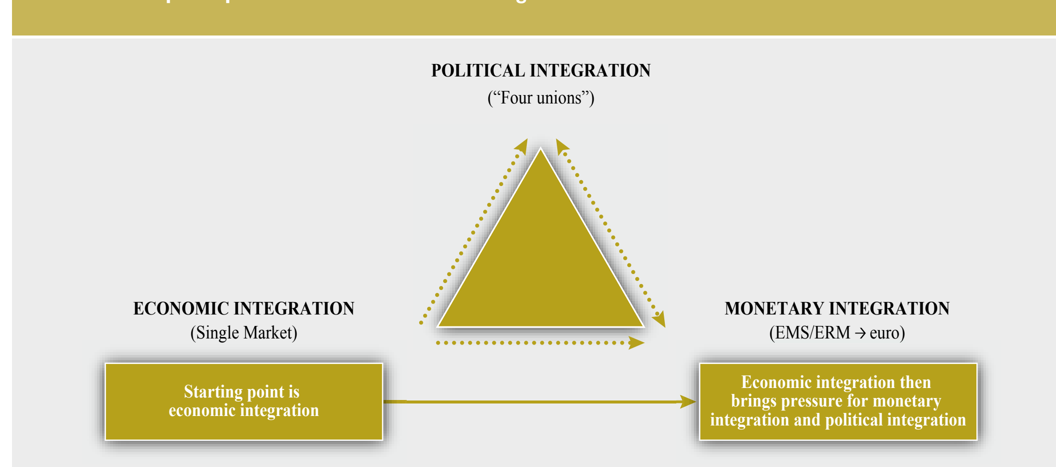
The fundamental laws governing economic activity – whether banking, industrial production or consumer protection – are also largely harmonised in the Single Market (with the exception of pensions and supervision). Thus, over these six decades there has been a continuing deepening of trade in goods and services as well as deeper financial linkages. Such **economic integration** is a diffuse process that advances slowly but steadily, while generating a stream of benefits – even today – for everyone in Europe. It has been the engine of Europe's integration, transforming it into the world's most open economic area.

Before launching the euro there were preparations and readiness, but...

The third force shaping Europe is **monetary integration**, which began with monetary cooperation in the 1960s, and progressed through various arrangements for exchange rate coordination from the

1 Several supranational institutions now enable the European Union (EU) to work, such as the European Commission, the European Parliament, and the European Court of Justice (see Dorrucci et al. (2004)). The EU presides over a limited budget for community tasks (about 1% GDP), thus cross-country risk-sharing is very limited. Today, workers and companies face no legal obstacles if they wish to move within the EU. Subsidies and regulations favouring domestic producers are prohibited, although some exceptions came about during the crisis.

Chart 1 European process of "functional integration"



1970s to the 1990s.[2] In the late 1980s the idea of irrevocably fixing exchange rates among a group of EU countries gained ground. Given the advances in economic integration, it was widely believed that various countries would be ready to share a single currency at the end of the 1990s. The Maastricht Treaty laid out the preparatory stages and specified the main Maastricht convergence criteria: i.e. deficit and debt reference values, inflation rates, interest rates and exchange rate volatility. All had to be within narrow margins or steadily converging, as in the case of the debt level. The aim was to secure nominal convergence prior to the euro's launch. However, a lesson of the crisis is that nominal convergence at a given point in time *per se* is not sufficient.

...there also were some warnings

During the run-up to EMU, some European economists advocated a deeper look at the effective degree of real economic and financial integration prior to the launch of the euro: were candidate countries flexible enough to allow an irrevocable fixing of their nominal exchange rates? Did they possess sufficient adjustment capabilities? See, for example, the 1992 Emerson Report: **"One Market, One Money"** (Emerson et al (1992).[3] Overall, their advice was either to launch the euro among a smaller group of countries, or to wait for more convergence to take place (several influential German economists wrote a letter to the German Chancellor advocating a delay in the start of the euro), or simply to continue focusing on real convergence issues upon the launch of the euro (see "*The Dark Side of EMU*" by Wyplosz (2006)).

Point 1. There has been **a three-way link between political, economic and monetary integration** – a point that has often been missed. Dorrucci et al. (2004) show that deeper political integration has a direct impact on economic integration (i.e. it "Granger-causes" it). However, also the converse is true: deeper trade and financial linkages over these 60 years have fostered additional institutional steps and thus political integration. To label EMU and the euro solely as a political project is incorrect.[4]

Perhaps a paradox of European integration is the lack of a shared political vision

While the political origins, motivations and consequences of European integration cannot be overemphasised, there has been no agreed-upon end-point, at least not yet. The question has been largely set aside in recent decades. *Why this omission?* After the "no" vote by the French National Assembly in 1954 – but also the rejection of the EU Constitutional Treaty by France and the Netherlands in 2005 (which was a shock for many) – a functional, stepwise process of integration was chosen. One result after many decades is that elements of a *federal Europe* now coexist with elements of a *confederal Europe*. The Eurosystem is federal in nature, while the EU Council brings together 27 Heads of State and Government. This implies continued tension between national and supranational

2 A little-known fact is that a Committee of Governors among central bankers started operating in Basel back in 1964. It had a bare-bones structure equipped with sub-committees – for discussing financial events, sharing best practices and agreeing on standards for statistics, economic analysis, international relations and other matters. They are still operationally functional in the structure of the Eurosystem (see Jung et al. (2009)). In 1990 the Committee of Governors prepared the first draft of the Statute of the ECB for the 1992 Maastricht Treaty. It also envisaged the supervision of banks as an ECB task. Later on, the Eurosystem's national roots and networks, plus the fact that European central bankers have been working together for over 40 years, has helped in the management of the crisis. The 1970 Werner Report led instead to the creation of a European Monetary Cooperation Fund.

3 There is often reference to a pre-euro debate between two fields. Supporters of the *"economist field",* championed mostly by German economists, postulated the need for closely coordinating economic policies and for a long convergence process to favour an alignment of monetary policies prior to the launch of the euro. Thus, monetary unification should follow a process of real economic convergence and is also called the "crowning theory". The concept of the "Own House In Order", or OHIO principle is a corollary of the economist field. The opposing view is the *"monetarist field"* championed mostly by French and Italian economists, which postulated instead that full nominal convergence was not indispensable prior to the launch of the euro as monetary integration would drive real convergence.

4 EMU and the euro also had a "defensive purpose", preventing ongoing exchange rate devaluations by "high inflation and high current account deficit" countries that were disrupting trade and financial flows and thus hampering the Single Market (a point often made by Issing (2008)).

tasks, responsibilities, interests and powers (see also Gaspar (2013)).[5] The need for a deeper sharing of sovereignty – and a crisis management framework – has emerged only under the pressure of the crisis. The shared political vision will return later in this paper when discussing the "four unions".

What was the covenant of EMU?

What did euro area governments agree upon? The governance of EMU entailed the handover of direct control of monetary policy to the ECB and the Eurosystem, weak forms of policy coordination and no risk-sharing arrangements or crisis resolution mechanism. There were no backstops for either sovereigns or systemic banks which might have stopped the crisis from spreading. The backbone of the political economy of the euro area was provided by the Stability and Growth Pact (SGP) with its *preventive arm* (to deter persistent excessive deficits) and *corrective arms* (to spur budget corrections). Later on the Lisbon Agenda was added to encourage product and labour market reforms and spur competitiveness. But both the SGP and the Lisbon Agenda had few teeth and a limited impact. Thus, no forceful adjustment mechanisms or processes were set up. With hindsight, *EMU's architecture was based on the assumption that euro area countries could keep their own houses in order* (which is also known as the OHIO principle).

Point 2. EMU scepticism was born with the euro. A large number of US-based academics, including Krugman and Feldstein, were doubtful that the euro area could function as a viable economic and monetary union. They had an Optimum Currency Area theory background and, in their view, euro area countries had too little labour mobility and no supranational fiscal arrangement comparable with the US Federal Budget, which can buffer economic shocks hitting some US states or regions. Another group of sceptics, both in the US and Europe, feels that an economic and monetary union cannot be viable without a greater degree of political union.

Point 3. "Aun aprendo": "*I am still learning"* (Francisco Goya). Other pundits, like Eichengreen, Obstfeld, Rogoff, Bordo and Garber were somewhat more nuanced. They pointed to specific flaws in EMU, such as the lack of a lender of last resort for sovereigns and the lack of centralised decision-making; in their view, EMU's political economy was born weak.[6] Sims (1999) asked instead whether euro area countries would be far-sighted enough to undertake what he calls "institutional learning". Specifically, Sims asked whether EMU's institutions were equipped to deal with "stress" and observed that *"...fiscal institutions as yet unspecified will have to arise or be invented in order for EMU to be a long-term success".*

To sum up. The **"uniqueness of EMU"**- i.e. a strong single market, a strong single currency, but modest political union, originates also from choices and constraints that emerged in the 1950s. Functional integration prevailed over a sharing of sovereignty and "genuine political union" (of the type that is being discussed today). There was also too little understanding of what EMU can and cannot do, and what types of shock it might endure. With hindsight, there was also a lack of scrutiny of the quality of real convergence and the need to strengthen adjustment mechanisms alternative to the national exchange rate instruments. Thus, systemic risks were in part endogenous, as discussed next.

5 Plus, there are cultural differences, varying welfare models and other barriers (Buetzer et al. (2012)).
6 For a survey of early EMU scepticism, see "It Can't Happen, It's a Bad Idea, It Won't Last: U.S. Economists on the EMU and the Euro, 1989-2002" by Jonung and Drea (2010). As a corollary, some see EMU as a fixed but "exitable" exchange rate regime (with perhaps future re-entry). This is not possible as a country can only leave the EU and would have to renegotiate its way back into the Single Market.

3 LIFE WITH THE EURO (I): 1999 – LATE 2009

What happened after the launch of the euro? What were its intended as well as unintended effects? To understand the sovereign debt crisis – and the adverse feedback loop between sovereigns, banks and the economy – several effects of the euro in its first ten years must be reviewed. To some extent, the achievements are linked with the severity of the crisis. Deeper cross-country trade, credit flows and FDIs, as well as growing financial exposures became the "vehicles" of the sovereign crisis. Equally baffling is that there was more macro-stability while persistent imbalances were building up over time: thus, the euro contributed to changing the nature of shocks hitting the euro area. Threats were no longer coming from idiosyncratic country-specific shocks; rather, they emerged from a lack of adjustment mechanisms, backstops and firewalls, and EMU's inadequate political economy.

3.1 FIRST TEN YEARS OF THE EURO: THE INTENDED EFFECTS...

From a strictly monetary policy perspective the first decade of the euro may well have been as good as many had hoped (Mongelli and Wyplosz (2009)). Inflation was low and inflationary expectations remained well anchored (even throughout the financial crisis). Moreover, many new jobs were created – 4 million compared with 1 million in the previous decade – and unemployment declined while labour market participation rose across most countries. Interest rates were also low at all maturities, for all borrowers and for all countries. This had several unintended effects, as discussed next. Throughout the crisis, the actions of the ECB and the Eurosystem, as well as other central banks, shored up the financial system, preventing even worse effects (Drudi et al (2012)).

Trade in goods and services among euro area countries rose by around 50% (evaluated at constant prices) between 1999 and 2011 (see ECB (2013)). As it outpaced growth in GDP, its share rose from 15% of GDP in 1999 to around 20% in 2011. Baldwin et al. (2008) come to a more modest conclusion and place the trade effects of the euro at about 2-3%. Still, these are very striking outcomes considering that European trade had already exhibited a tenfold real increase since the 1960s. Remarkably, services trade grew even more than proportionately, reaching about 20% of total trade. Hence, internal openness grew significantly. Meanwhile, extra-euro area trade grew even faster due to the more dynamic world economy. Therefore, no "fortress Europe" was erected and the financial crisis only temporarily dented trade.

The euro has also had a significant impact on various financial market segments (see various ECB reports entitled "Financial Integration in Europe" (ECB (2012a)). In bond and equity markets integration has advanced steadily, aided by the removal of currency-matching restrictions. International ownership of public debt of euro area countries rose from 32.5% in 1999, to 53.5% in 2009. Substantial cross-country holdings of Greek, Irish, Portuguese and Spanish bonds built up (normal in a monetary union). Money markets integrated after the introduction of the euro, particularly the secured segment. The rapid integration of wholesale capital markets contrasts with the modest changes on the lending side: most banks basically kept their exposure, and thus risks, domestic (OECD (2010). The euro area has been a magnet for internal FDI activities. Companies and, to a lesser extent, banks and other financial institutions started to have a more continental reach (but still not like that of big US banks). Integration among banks and stock exchanges advanced only slowly.

Point 4. Becoming each other's stakeholders. This deep trade and financial integration, which some call interdependence, was no surprise: it had long been postulated by Andrew Rose and Jeffrey

Frankel as the "endogeneity of the optimum currency area", which may require up to 30 years to fully unfold. In retrospect, the expected endogeneity bred some wishful thinking (see De Grauwe and Mongelli (2005)) and might have distracted attention from a more objective look at the quality of financial integration, the modest risk diversification and the growing severity of the imbalances, that is discussed next.

3.2 … AND THE UNINTENDED EFFECTS: NOT ALL WENT AS DESIRED IN THE FIRST TEN YEARS

During the first ten years of the euro three fault lines were allowed to build up over time, leading to substantial imbalances (Shambaugh (2012) and Cœuré (2013)). Countries at the intersection of these fault lines are now the most "stressed".[7]

The **first fault line is the result of weak public finances** and less room for fiscal manoeuvre in several euro area countries. This is, however, a rather complicated story. Euro area debt-to-GDP ratio declined from about 72% in 1999 to about 66% in 2007. But this reduction was both limited and uneven across countries.[8] Ireland and Spain had actually strengthened their public finances, also helped by the housing and cyclical boom. Both countries were hit hard by the financial turmoil and global financial crisis when cheap and abundant funds faded.[9] By varying extents during the crisis, governments had to take on private debt in order to rescue domestic banks. Public debt rose (as did guarantees to the financial system). At the same time, revenues contracted and cyclical spending increased (fiscal stabilisers). As the economy shrank their cyclically-adjusted balances worsened and public indebtedness soared with each new release of macroeconomic data and surveys. Concerns about fiscal sustainability emerged.[10] In synthesis, the favourable first decade with the euro was not used to reduce public debt ratios faster in the stressed countries.

The **second fault line comprises persistent current account imbalances** in another overlapping group of countries. Since the launch of the euro, real exchange rates of euro area countries – i.e. their relative competitiveness – changed quite substantially. In the period from 1999 to 2007, a harmonised competitiveness indicator (HCI) compiled by Eurostat appreciated by almost 23% in Ireland, about 15% in Spain, and almost 10% in Portugal and Greece, while remaining practically unchanged in Austria, Finland and Germany. A look at cumulated changes in current account positions over the same period reveals a surge of surpluses by about 6% of GDP in Germany and Austria, and a widening of current account deficits of about 6% of GDP or more in Ireland, Spain, Portugal and Greece. The ECB had repeatedly cautioned against such persistent imbalances (see Trichet (2006) and ECB (2008)).

The **third fault line is the slow pace of productivity growth and GDP growth** in some other euro area countries, for example in Italy and Portugal which have had a slow pace of innovation and research and development (R&D) for several decades. The crisis has slowed economic activity,

7 The "stressed euro area countries" are sometime grouped as the "periphery" (see Pisani-Ferry (2012)), or the PIIGS, or the PIGS: catchy acronyms that simplistically lump together very different cases

8 Nearly no country complied to the fiscal rules even in good times, when taking adherence to the medium term objectives (MTO) as benchmark. And many did not comply with the 3% threshold either (see ECB (2008) for a review over the first euro decade).

9 Yet, despite similarities, there are national stories and each of country followed a different path For example, Ireland experienced a credit boom that in turn fuelled a boom in real estate. Income taxes were lowered and fiscal policies became increasingly reliant on tax revenues from building companies and from property sales, i.e. reliant on the housing bubble. In the meantime, soaring domestic non-tradeable prices and wages led to steady losses in competitiveness. Various manufacturing activities shrank, jobs were lost, and after the housing bubble burst and the crisis hit even harder, fiscal policies rapidly became unsustainable. Ireland today is implementing an EU/IMF adjustment programme (see also Marzinotto et al. (2010)).

10 Germany and France saw a rise in sovereign debt levels but are now enjoying record low funding costs. However, Italy, despite making some progress prior to the crisis, has ended up now paying much more to service its debt than it did in the mid-2000s, when debt ratios were higher. This apparent paradox is explained by the next fault lines.

lowered potential output growth (at least temporarily) and expedited a sharp reassessment of debt sustainability inside EMU This explains, in part, the widening sovereign spreads of stressed countries.

There is a possibility that the fault lines are symptoms of deeper epochal trends. A possible common denominator is that in several countries overall economic activity exceeded sustainable output trends for a long time. In other words several euro area countries lived for a long time above their means: they borrowed against future incomes that were in the meantime shrinking. These countries will need new "social covenants" or "social contracts". Another common denominator lies in the failings in both prudential supervision (also called micro-prudential), and macro-prudential supervision and systemic risk analysis. Yet, these denominators were common also to the US, the UK and many other countries. For example, the IMF postulates that post-crisis trend growth must be revised downward for all advanced economies: let's call this the "decline hypothesis" (see IMF (2012)). Hence, we need to find some failings that are specific to the euro area.

What happened?

Upon the launch of the euro several euro area countries entered a new – for them – low-interest-rate-and-low-inflation environment coupled with looser financial constraints. There was a broad credit boom that boosted domestic demand, e.g. to fund construction in Spain and Ireland, and consumption in Greece and Portugal. Massive capital flows were channelled through the banking system to households, as well as financial and non-financial corporations and governments of the above countries from the other euro area countries (see Gros (2012)).

What happened…really?

One hypothesis is that wage setting, fiscal policies and overall investment decisions in the countries now experiencing the most difficulties seemed to continue to be based on the possibility of bouts of domestic inflation and exchange rate devaluation reducing real wages and the real value of outstanding debt (public and private), while regaining competitiveness (see Papadia (2012)). But such adjustment mechanisms were no longer available. Thus, all along, these economies took for granted excessively low interest rates. If such **"behavioural inertia"** is confirmed empirically, at least for the initial years following the launch of the euro, it might also imply that the **responsibilities for the sovereign debt crisis are more diffuse than previously thought.** In some sense, the sovereign debt crisis could also be interpreted as a painful lesson. But still, such inertia cannot explain why the "North" financed the "South"; the expected returns German, French and Dutch banks might have had; and other financial developments.

In any case, the OECD (2010) has noted that there was a dangerously high reliance on short-term cross-country funding (e.g. through money markets) with only modest integration in terms of risk-sharing. A banking union was also absent. The crisis has partly undone this shallow financial integration and various financial market segments are now impaired in several euro area countries – the main reason for the ECB's exceptional standard monetary policy measures (i.e., very low interest rates) as well as exceptional non-standard measures (i.e., unlimited long-term refinancing at fixed low interest rates, see Drudi et al. (2012)).

What is sure is that **two deterrents failed and one was completely missing.** The *preventive arm* of the SGP did not work as hoped. At the time, the European Commission did not have enough support to fully enforce the *corrective arm* of the SGP and push for more timely reductions of deficits and debt at national level (although it did try to take some countries to court). In November 2003, the

implications of the SGP were rejected by France and Germany. The SGP was then revised in 2005 (and various mitigating conditions were added).

At the same time, upon the launch of the euro, the cost of sovereign borrowing converged (which was also a requirement of the Maastricht Convergence criteria). During the first decade of the euro, financial market participants and credit rating agencies did not sufficiently discriminate between national issuers with different legacy debt and credit standings. Some say that there were no "*bond vigilantes*", and sovereign risks were persistently under-priced. Euro area countries were treated in almost the same way. *Was there an implicit expectation of country bail-outs? Did this reflect a disappearance of perceived credit risk?* Incidentally, this was the case also for all credit risks of all OECD countries. In any case, for what concerns us, both EU institutions and financial markets did not encourage faster deficit and debt reduction.

Point 5. Looking the other way? The real missing deterrent concerned the cumulative macroeconomic imbalances (and thus growing systemic risks) emerging from the three fault lines. There were no mechanisms to discourage persistent budget deficits and current account deficits, an erosion of competitiveness, rigid labour and product markets, low growth in productivity and innovation, excessive financial leverages and undercapitalisation, and/or excessive borrowing by households, companies and banks. These countries seemed successful as they were posting high growth rates and had low unemployment.

3.3 ANOTHER STORY WAS ALSO UNFOLDING: GLOBAL SYSTEMIC RISKS WERE BUILDING UP

As is now well known, over the last 15 years various global phenomena led to the accumulation of "global systemic risks".[11] There were only a few, and unfortunately overlooked, warnings by Nouriel Roubini (see RGE Monitor), Bill White while at the BIS, Nassim Nicholas Taleb and a few others. In August 2007, the materialisation of such risks gave rise to financial turmoil. Money markets were hit and lending dried up. Despite the liquidity provision by most central banks, various banks collapsed or were nationalised (e.g. Northern Rock, Royal Bank of Scotland and Fortis). The US Federal Reserve bailed out Fannie Mae and Freddie Mac, American Investment Group (AIG), and various public companies. Then, after Lehman's bankruptcy in September 2008, the world was struck by a sudden systemic financial crisis, unprecedented in size, when measured by financial losses and fiscal costs, unprecedented in extent, when measured by its geographical reach, and unprecedented in speed and synchronisation, when measured by the precipitous fall in worldwide economic output (in developed economies).

Money markets seized up. International trade plummeted, which affected euro area economies disproportionately due to their high openness. In the euro area, the construction sector in many countries came to a standstill due to a shortage of funding, and unemployment climbed to levels not seen for decades. Budget deficits soared in several countries due to a drop in many sources of revenue and the expense of stimulus packages to counter the slowdown in growth. Several governments also had to launch various initiatives to support their banking sectors (via state guarantees, capital injections, loans or partial nationalisation).

11 "Globalisation" and the "savings glut" in fast growth emerging economies and commodities exporters, contributed to both a "low inflation" and "low interest rates" environment worldwide. This in turn contributed to the "great moderation" – i.e., a 15 year period in which the world benefited from price stability and sustained growth in all regions. Yet, this encouraged a search for yield to which the banking system responded in several manners. On the liability side, banks changed their business model, by relying more and more on wholesale funding. On the asset side, there were diverse financial innovation, and large volumes of sub-prime mortgages (whose intrinsic risk was misunderstood) were repackaged and sold worldwide – that is termed the originate to distribute approach (OTD). Finally, financial regulation and supervision trailed behind these developments, and so on.

Point 6. It appears that in the fields in which sovereignty is shared – as in the case of monetary policy, exchange rate policy and competition policy – things worked out reasonably well. Strong forms of coordination, like the SGP, had an uneven effect, whereas weak forms of coordination, such as the Lisbon Agenda to spur structural reforms or the Lamfalussy process, were ineffective.[12] That is an important element behind the drive towards EMU's new political economy with the fiscal compact, the four unions and greater sharing of sovereignty in new policy areas (discussed below).

To sum up. There was a lack of domestic adjustment mechanisms. It was not understood that systemic risks were growing in the euro area due to the increasing economic and financial interdependence, as the crisis would soon show. Former ECB President J.C. Trichet once remarked that the SGP should instead have been a SGCP: a Stability, Growth and Competitiveness Pact. The OECD (2010) notes that persistent structural differences and an accumulation of savings-investment imbalances are hard to deal with in a monetary union and can trigger negative consequences thereafter (which it did).

12 The Lamfalussy process is a new approach to the development and adoption of the European Union's financial services legislation.

4 LIFE WITH THE EURO (II): LATE 2009 – END 2012

Remarkably, until the end of 2009 no euro area sovereign was under direct threat and sovereign spreads remained relatively narrow. While some banks faced financial difficulties from their exposure to US-originated sub-prime financial assets, the euro area's banking system overall held up thanks to ample government support, ECB liquidity and the emergency lending assistance (see Drudi et al. (2012)). But the conviction that euro area membership would provide a shield against all risks soon vanished; although exchange rate risks had gone, credit risks roared back.

4.1 THE SOVEREIGN DEBT CRISIS

In late 2009 the financial environment deteriorated with the emergence of the first sovereign debt crisis in Greece. *What happened?* In autumn 2009 the newly elected Greek government audited the national public finances going all the way back to the adoption of the euro in 2002. The findings were shocking. There had been widespread misreporting and off-balance sheet mechanisms which had allowed part of public spending to be concealed. With each upward deficit revision, concerns about Greek sustainability surged (see Dellas and Tavlas (2012) for an analysis of the Greek crisis). Risk aversion rose.[13]

Then, in early May 2010, the ten-year yield spread between Greek and German government bonds reached a historical high of about 1,000 basis points (it subsequently touched 4,000 basis points in early 2012). This was the point of no return and Greece adopted its first EU/IMF adjustment programme. While Greece was the spark, concerns about the public finances and financial health of other euro area countries rose. Talk about retroactive bail-ins of private investors holding Greek bonds via private sector involvement (PSI) was the fuel. Sovereign spreads soared at the same time, but to different degrees, as did spreads on credit default swaps (CDSs) in Ireland, then Portugal and later in Spain, Italy and Cyprus. Risk aversion rose everywhere. Thus, there was financial contagion.[14]

Successive sovereign debt rating downgrades ensued. This was accompanied almost in parallel by downgrades of most bonds and other marketable securities issued by banks and firms of these countries. Several governments had to support domestic banks – through state guarantees, loans and/or capital injections – which in turn weighed heavily on fiscal sustainability. Banks responded to their weaker balance sheets by deleveraging (a challenging act for the economy) – and recapitalising (later required also by the European Banking Authority (EBA)).

Yet, as market conditions worsened and the downgrades accelerated, it became increasingly difficult to recapitalise the banking system, thus creating an ***adverse feedback loop*** between weakening sovereigns, fragile banks and shrinking economies (see Shaumbaugh (2012). As most economies shrank and unemployment soared, the fiscal consolidation effort needed to restore confidence in sovereign markets kept on rising. Some EMU critics have asked if protracted austerity will work or, given the magnitudes involved, if it might in the end be illusory and self-defeating, or even tip some euro area countries into a deflationary spiral. In any case, with its actions, the Eurosystem prevented an even more severe credit crunch and illiquidity spiral for the sovereign debt markets of the whole euro area (see Drudi et al. (2012) and Schoenmaker (2011)).

13 In November 2009 financial markets were also shaken by the financial difficulties of Dubai World, which was subsequently bailed out by Abu Dhabi.

14 De Santis (2012) finds that a one-notch downgrade of sovereign bonds in Greece, Ireland and Portugal is associated with a rise in the sovereign spreads of other countries with weak fiscal fundamentals.

4.2 TWO INSTITUTIONAL OMISSIONS MERIT SOME EXPLANATIONS

The governance of EMU was designed without a framework to deal with a sovereign debt crisis (Yiangou et al. (2012)). Yet a medium-term financial assistance facility exists for balance-of-payments crises in non-euro area EU Members (such as Latvia, Romania and Hungary). The second omission was a common resolution framework for large pan-European banks – the so-called systemically important financial institutions (SIFIs). Such frameworks were still national, even though several banking groups had balance sheets that grew to several multiples of domestic GDPs. EMU had been built without the necessary firewalls and backstops. These were meant as a deterrent to underpin the no-bailout rule, but didn't work. To build on the analogy: there were no European firewalls, no fire hydrants, no fire trucks, and no fire insurance premium was being raised to pay for this. These elements were introduced later.

Point 7. Once the sovereign crisis erupted, the ensuing ***dysfunctional policy debate*** and the fractious national responses were also harmful. Understandably, national disaffection rose, as did scepticism about the resilience of the euro area. The mood towards the euro started turning. It worsened over time, with countries pitted against each other for "*not giving enough*" or "*wanting too much*". Some people recalled dark moments in Europe's history clouding the policy debate. Some even feared the emergence of a bailout union, a transfer union, or of debt mutualisation. Neologisms have been created, like "Grexit" and so forth, and a "re-denomination risks" is priced in by financial markets. There are also fears about the hegemony of some countries, a permanent loss of sovereignty, or even political subjugation (see the recent declarations of a former Italian PM). The ranks of "EMU sceptics" swelled further, while the early EMU sceptics considered themselves justified by events; for a survey see Bornhorst et al. (2012). Sovereign spreads and credit default swaps rose as well. Yet, none of these fears was justified.

4.3 DENIAL? ...NO MORE

Initially, stressed countries might have been largely in denial about the need to tackle their imbalances. Precious time elapsed as it took a long while for national policy-makers, social partners (labour unions and employers' associations) and households to become fully aware of the increasing gravity of the situation, accept the reality and acknowledge the mounting systemic threats. In the meantime, over the last two to three years, a harmful feedback loop has further weakened several sovereigns, their resident banking systems and their domestic economy. On several occasions the financial system of the euro area has been almost paralysed and has only stepped back from the brink due to the exceptional non-standard monetary policies of the ECB and Eurosystem (Drudi et al (2012)), the strong fiscal stimuli, as well as the collective responses of European institutions (see Schoenmaker (2011)).

4.4 IS TINA NOW FINALLY WORKING?[15]

Are there trade-offs? On the one hand, the legacy of the crisis is now more severe in the stressed countries: i.e. the three "programme countries" as well as those under extreme financial market pressures (Spain, Italy and Cyprus, plus others). On the other hand, in each of these countries there is wide awareness of the gravity of the situation. Thus, on the structural side, there is no longer any denial of the situation and there are changes in behaviours as well as an acceptance of reforms and fiscal consolidation. There is already evidence that the adjustment process has started in earnest.

15 TINA is the acronym of "There Is No Alternative", a phrase closely associated with British Prime Minister Thatcher, who believed profound labour and product market reforms were inescapable and could no longer be deferred.

Yet some sort of "warfare" is still ongoing on the financial side. A much discussed issue concerns the burden of the adjustment: should it fall principally on deficit/debtor countries, or also on surplus countries? These critics observe that every system with asymmetric responses has broken down in the past. Please see Section 6 for more arguments on this point.

4.5 WHAT IS THE ECONOMIC AND FINANCIAL LEGACY OF THE CRISIS THUS FAR?

Tackling heterogeneity...

The financial crisis, and in particular the sovereign debt crisis since early 2010, have rapidly exacerbated existing imbalances and entrenched divergences within the euro area. There is substantial heterogeneity in public indebtedness, and segmentation in several financial market segments (see ECB (2012c)). Money markets and sovereign markets are still dislocated in several countries, and the monetary transmission mechanism is dysfunctional, with a non-uniform transmission of monetary policy decisions across the euro area. As for the real economies, there is still widespread heterogeneity in competitiveness, output and employment developments. Concerning banks, several have needed significant recapitalisation and restructuring, and a few have been partly nationalised (completely or in part). In various euro area countries, bank deleveraging and recapitalisation has been accompanied with a credit crunch. Only in the latter part of 2012 there were some sustained improvements of financial conditions and a partial reversal of financial outflows from the euro area.

... but there is an elephant in the room[16]

There is a legacy of the last 10 to 15 years that is still little understood: the ***"specialisation and concentration hypothesis"*** that has been driven by two forces:

- The first results from the economies of scale encouraged by the euro itself. Several industries might concentrate in fewer countries, and there may be a "hollowing-out" of manufacturing in the countries losing out (Krugman (1998)). For example, the car industry is now more concentrated in Germany and France, the pharmaceutical industry is concentrated in Germany and Ireland and so on.

- The second force originates from the exuberance that accompanied the launch of the euro. Financial services and construction underwent a boom in Spain, Greece, and Ireland (and elsewhere) at the expense of other traditional industries. Credit channelled by large European banks was abundant and cheap. The booming demand drove domestic salaries up in the non-tradable sector, but then also in the tradable sector. The general price level rose, depressing production in the tradable sector, which was becoming less and less competitive.

As a result of both forces, Greece, Portugal, Spain and Italy now produce fewer manufactured goods and in smaller quantities than 15 years ago; their economies have become – at least temporarily – less diversified.

Stay where you are... Thus, the euro may have unintentionally accelerated a concentration and specialisation process, which in turn has two implications:

- The first is that part of the current account deficit of some countries becomes structural (*ceteris paribus* and for a given standard of living). Traditional policy remedies are less effective in such a case.

16 Inspired by the Last Lecture of Pausch et al (2009), the US computer science expert who gave a public talk and wrote a book on life – and its rewards and challenges – despite being terminally ill.

- The second implication is that an exit from the euro might bring fewer benefits than hoped for. For example, Greece may have a quantity issue: not many traditional goods and services to export, while its largest industries – tourism and shipping – might actually benefit from the euro's stability and EMU's financial anchor and institutional framework.[17]

…but reinvent yourself. Thus, there is a need to "reinvent" parts of the manufacturing and also service sectors of various euro area countries. They have to reinvent parts of their economies: enlarge the supply sides (i.e. a "new Greece", a "new Portugal" and even a "new Italy" should emerge). Structural reforms and liberalisation help innovation and the freeing-up of resources. But all in all, exiting the economic and financial dimension of the crisis might be a slightly longer process than previously thought.

Point 8. In case of sovereign crisis, various approaches have traditionally been used to tackle unsustainable indebtedness (both public and private). Sustained budget and current account surpluses can reduce the stock of debt, but only slowly. Since the end of WWII, the principal counterpart has been the IMF and debt rescheduling has been obtained – in a coordinated manner – through the Paris Club (for multilateral public debt) and the London Club (for commercial private debt). These venues were precluded in Europe. This entailed a painful learning process (see Buti and Carnot (2012)).

To sum up, several euro area countries are at least temporarily less flexible (as they have exhausted their fiscal stabilisers and are under financial pressure), less open towards each other and also exhibit weaker macroeconomic correlations (these aspects are discussed further in Section 6).

17 The fact that import-competing or wider export industries do not exist today in Greece does not mean that they cannot start emerging relatively rapidly (a point made by Geoff Barnard). Professor Haliassos (Goethe University) mentions medical tourism and bio-engineering as possible new industries.

5 THE RESPONSES TO THE SOVEREIGN DEBT CRISIS OF THE EURO AREA

As Jean Monnet once noted, *"Europe will be forged in crises, and will be the sum of the solutions adopted for those crises"*. Over the last 24 to 36 months policy-makers have tackled what is often referred to as the "design flaws of the euro area" or the "incompleteness of EMU" and engaged in a concerted effort of "European institution-building". A new "constitutional framework" is emerging, heralding a greater sharing of sovereignty as well as some risk-sharing and financial backstops (Mayer (2012)).

5.1 THERE IS MORE RISK-SHARING THAN IS GIVEN CREDIT FOR

Various mechanisms and policies have helped preserve the integrity of the euro area and support the wide reform process. EMU was designed without a common facility to help resolve a sovereign debt crisis or a banking crisis. While the first risk-sharing mechanisms were based on bilateral loans for Greece, the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) subsequently filled this institutional gap. The use of these risk-sharing and adjustment facilities is subject to a sovereign resolution framework and various degrees of conditionality in the form of "adjustment programmes" monitored by the European Commission, IMF and ECB.[18] The financial backing of the EFSF comes from joint and mutual national guarantees in proportion to the share of ECB capital (Germany 27%, France 20%, Italy 18% and so on). Obviously, the backing of the AAA/AA carries a higher weight vis-à-vis financial markets and credit rating agencies.

The ESM was established as a permanent international institution (in contrast to the EFSF) with a number of instruments at its disposal, including loans, precautionary assistance (so-called Precautionary Conditions Credit Line (PCCL) and Enhanced Conditions Credit Line (ECCL)), primary market bond purchase, secondary market bond purchases, and loans for recapitalisation of financial institutions. The capital structure of the ESM operates on the basis of both paid-in (€80 billion) and callable (€620 billion) capital by the euro area countries, making it the 'most capitalised financial institution in the world', with an effective lending capacity of €500 billion.[19] Moreover, it is more flexible than the EFSF in its decision-making structure. Once an effective single supervisory mechanism (SSM) has been established, the ESM will have the possibility to recapitalise banks directly (see Euro Summit statement, 29 June 2012).

Another form of risk-sharing stems from the International Monetary Fund's financial and technical assistance to the programme countries.[20] A third source of risk-sharing stems from government support to the domestic banking system: because several banks had operations spanning various countries, when the German, French, Dutch and Belgian government were recapitalising in various ways their systemic banks, they were *de facto* also supporting their foreign operations and an orderly deleveraging and withdrawal of operations in stressed countries (e.g. Credit Agricole vis-à-vis Emporiki Bank in Greece).

Moreover, the standard and non-standard monetary policy measures of the ECB and Eurosystem have addressed financial market dysfunctionalities and helped reduce the impairments in the

18 A possible arrangement for Spain's Bankia is an example of indirect recapitalisation via EFSF/ESM loans to the Spanish government. Direct recapitalisation of large and systemic banks via EFSF/ESM will only become possible subject to conditionality and once a single supervisor has been set up.

19 A drawback is that its acceptance hinges on the "goodwill" of those countries which still have financial market access and particularly the "AAA/AA/A-rated" ones (see Jean Pisani-Ferry's recent Bruegel Policy Contributions and Briefs).

20 The IMF's consolidated programme expertise and financial clout has immediately granted credibility to the programme and anchored expectations.

transmission of monetary policy measures particularly across the most vulnerable (but solvent) banks in stressed euro area countries (but against adequate collateral subject to haircuts). Implicitly, this has also represented a risk-sharing mechanism (see Papadia (2012)). Criticisms have been aimed at this mechanism by Sinn as well as other German economists (Sinn (2011)). Target2 balances have been declining in recent months.

5.2 THERE IS A NEW GOVERNANCE

The increased degree of risk sharing makes also a strengthening of the governance framework necessary to counter moral hazard inherent in any insurance scheme. There is now a "European Semester" with transparent timelines to improve surveillance of national policies and improve economic policy coordination (Praet (2012)). The most far-reaching reforms so far are included in the so-called *"six-pack"* of legislative measures comprising five regulations and one directive came into force in December 2011. It ensures more automaticity and stricter application of fiscal rules in addition to stronger enforcement of the preventive and corrective arm of the SGP; the introduction of a expenditure rule in the preventive arm of the SGP and the reinforcement of the debt criterion in the excessive deficit procedure; a more modular use of fines in case of non-compliance; stronger national fiscal frameworks; and the Macroeconomic Imbalances Procedure (MIP) to screen both external and internal imbalances (by means of a scoreboard of variables) and impose financial sanctions on euro area member states for persistent imbalances.

The *"two-pack"* consists of two regulations which aim to further strengthen budgetary and economic surveillance and restore confidence in financial markets. The Commission's proposal envisages the publication of Member States' medium-term fiscal plans, the *ex ante* assessment of national budgetary plans of euro area Member States, and even stricter monitoring of Member States in the Excessive Deficit Procedure (EDP). The first regulation is aimed in particular at giving new powers to the Commission to assess and, when necessary, request a revision of draft national budgetary plans as well as to ensure the correction of excessive deficits. The second regulation proposes new provisions allowing the Commission and the Council to step up the surveillance of the macroeconomic, financial and fiscal situation of euro area Member States experiencing or threatened with serious difficulties in terms of financial stability.

To confer an even higher status on national commitments to fiscal discipline, all EU members – except the UK and the Czech Republic – recently signed a *Treaty on Stability, Coordination and Governance* in the Economic and Monetary Union (TSCG). This new intergovernmental treaty, which came into force at the beginning of 2013, has three parts:

- The first is the *Fiscal Compact*, envisaging the transposition into national law of the balanced budget rules of the preventive arm of the SGP including an automatic correction mechanism. The European Court of Justice will supervise this transposition while application rests with member states. Additionally, the fiscal compact strengthens the automaticity in the excessive deficit procedure of the SGP further.

- The second part includes a commitment to additional policy actions to improve convergence and competitiveness and envisages even stronger economic policy coordination. Germany had already adopted the debt brake well before the fiscal compact. Spain also introduced a balanced budget rule, and discussions are advancing in Italy.

- The third part aims at improving political governance of the euro area.

Chart 2 Treaty on stability, coordination and governance (TSCG): overview of main provisions

Title III: Fiscal compact	• Balanced budget rule including an automatic correction mechanism to be implemented in national law • Strengthening of the excessive deficit procedure • Enshrines the numerical benchmark for debt reduction for Member States with governement debt exceeding 60% of GDP • Ex-ante reporting on public debt issuance plans
Title IV: Economic policy coordination and convergence	• Commitment to take additional policy acions fostering a smooth functionning of EMU and economic growth through enchanced convergence and competitivesness • Ex-ante discission and, where appropriate, coordination of major economic policy reforms to benchmark best practices
Title V: Governance of the euro area	• Organisation of Euro Summit meetings a last twice per year • Conference of representatives of relevant committees of both the national parliaments and the European parliaments on the issues covered by the TSCG

Only those countries that have ratified the TSCG (see Chart 2 above) will have access to the financial assistance from the European Stability Mechanism (ESM). A "*quid pro quo*".[21]

5.3 THE NEW FINANCIAL SUPERVISORY FRAMEWORK

The first decade of the euro financial system was characterised by an uneven exchange of information, different supervisory and regulatory practices, and different resolution procedures across euro area countries. The incentives to cooperate were weak well into the crisis. Fortunately, progress was rapid in the financial area and, following the recommendations of the de Larosière report, in February 2009, a new European System of Financial Supervision (ESFS) came into operation. It consists of the following two "pillars": First, a *micro-pillar*, which covers micro-prudential supervision and established three new supervisory authorities to replace the so-called "level 3" committees (CEBS, CEIOPS and CESR), namely the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). Supervisory colleges for pan-European banks are also starting to operate. This structure however is still largely decentralised, preserving supervision at national level. Second, there is a *macro-pillar*, which is dedicated to macro-prudential supervision and is centred on the European Systemic Risk Board (ESRB). The ESRB can issue warnings and macro-prudential recommendations whenever necessary.

Moreover, the EU's new Capital Requirements Regulation (CRR) and Capital Requirement Directive IV (CRD), and the EBA resolution concerning an adequate Core Tier 1 capital ratio) are being implemented to ensure that banks are adequately capitalised. This is being done in a similar fashion for insurance companies with the Solvency II directive, which however has been criticised as being pro-cyclical in downturns (see Constâncio (2013) and Ayadi et al. (2012))). A trade-off noted by some is that, for a short transition period, compliance with these regulatory standards may be harming new lending and thus economic activity.

21 US States can count on a Federal Budget with redistributive features following an asymmetric shock. Moreover, US States are also largely forbidden from issuing public debt. Thus, national fiscal discipline is essential for EMU's long-term viability because of the lack of a centralised budget in the EU/euro area, but also because of the large spillover and negative external effects of unsustainable fiscal policies in EMU. Hence, fiscal discipline is also a public good, which needs to be provided by the Member States.

5.4 MORE IS ON THE HORIZON.

Glimpses of a shared European vision for the future are starting to emerge, as shown in the proposals for a new architecture – in the financial, fiscal, economic and political domains – made by the Presidents of the European Council, the European Commission, the Eurogroup and the ECB: i.e. the "Four Presidents" (see European Council (2012))[22]. This vision was endorsed at the EU Summit in late June 2012. In the economic domain, for example, the feasibility of contracts for competitiveness and growth and the coordination of national reforms will be explored in 2013 (see European Council Conclusions, 14 December 2012). Moreover, a course is now being set to create a *"financial union"* with a *"banking union"* at its core in 2014 (Constâncio (2013) and Véron (2012a)).[23] The aim is to harmonise pan-European banking regulation and supervision by establishing a single supervisory mechanism, a single regulatory rulebook and a single supervisory "handbook".

The banks, please. The landmark agreement at ECOFIN in December 2012 proposes that the ECB take responsibility of the SSM for banking supervision by 1 March 2014. Under the proposal, the ECB would directly supervise banks that have total assets of over €30 billion, represent over 20% of GDP or receive financing directly from the ESM. Moreover, the ECB would supervise at least three of the most significant credit institutions in each participating Member State. Moreover, the ECB will have the right to take any bank under its direct supervision. This represents a major step towards the establishment of a fully-fledged financial market union. To further safeguard stability and secure an effective framework for the resolution of financial institutions, the Commission will come forward in 2013 with proposals to establish a single resolution mechanism (see European Council Conclusions, 14 December 2012).

Who pays to rescue a bank that is "too large to fail"? The EFSF/ESM can already indirectly recapitalise large European banks, but subject to conditionality. Yet, later on, the funding for such a scheme may come from an escrow account to which all banks contribute in good times: hence, risks for taxpayers will be reduced (see ECB (2012b), Pisani-Ferry et al. (2012) and Pisani-Ferry (2012)). The banking union should have been discussed in combination with a *"fiscal union"* and shared macro and financial supervision, perhaps by an EU/euro area ministry of finance, over national budgets and budget execution (see Véron (2012b)).[24] In this sense the EU Summit of 14th December 2012 fell short of expectations.

Point 9. Yet the funds commanded by the EFSF and the recently established ESM, even at the theoretical upper limit, effectively account for only about 4-5% of euro area GDP, or about two to three years of potential growth for the euro area. Theoretically, the capital base of the ESM could be expanded. But *fears of a bailout union, or even a permanent transfer union,* would mean that resistance would be considerable. Thus, *de facto*, the EFSF/ESM funds are not easily expendable. However, if well used, these scarce funds might stop contagion, stem credit crunch and grant a fighting chance to the adjustment programmes under way.

22 The European Parliament outlined its vision for a deep and genuine EMU in October 2012, and the EU Commission adopted a 'Blueprint for a deep and genuine EMU' in November 2012, see: http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/pdf/blueprint_en.pdf

23 The choice of delaying a banking union was made already at the time of the Maastricht Treaty in 1992: it would not have been feasible back then. In any case a full banking union would still need bank resolution and joint deposit insurance scheme which are still under discussion.

24 It may also entail a moderate euro area budget to address common or idiosyncratic shocks. Later on, Eurobonds, for which several schemes exist (such as covered and red bonds), could then also be contemplated once full fiscal union is in place. It is unclear whether eurobills would be acceptable sooner.

To sum up, once completed, the new "constitutional framework" will provide a more stable framework and environment for the fiscal adjustment, the deleveraging and recapitalisation of banks, the balance sheet adjustment of households and firms, and the "reinvention" of diverse euro area economies. It will also diminish future systemic risks and reduce the threats of either fiscal or financial dominance (Asmussen (21012)). Several sceptics note that creditors as well as debtors should bear the burden of adjustment as a debtor-only adjustment cannot work. But this burden sharing is exactly what is now happening by means of various risk-sharing mechanisms.

6 ANOTHER WAY TO LOOK AT THE CRISIS: BE OPEN, FLEXIBLE AND...STAY CORRELATED

Is there another way to illustrate the evolution of the euro area over the last 10 to 15 years and show the impact of the crisis? Can the euro area become a sustainable economic and monetary union? The answer to both questions is yes. The answer makes use of the optimum currency area (OCA) theory. At its most basic level, the OCA theory is about openness, flexibility and correlation. Thus, euro area countries need to be:

- *"open"* vis-à-vis each other in terms of trade in goods and services, as well as financial integration. This reduces the usefulness of national exchange rates, spurs competition, improves the allocation of resources across the area and fosters growth;

- *"flexible"* in terms of domestic prices and costs of production, but also the mobility and adaptability of labour and the use of capital or other resources. Labour mobility is intended both as geographical mobility (within countries and across the currency area), and occupational mobility (across jobs in different industries or services). Flexibility is enhanced, among other factors, by a higher level of education and labour market participation, R&D, improved labour matching, productivity growth (which *ceteris paribus* reflects labour costs), and innovation (which permits the reallocation of idle resources). In case of a recession, the fiscal stabilisers grant some automatic adjustment – thus flexibility – provided that there is fiscal room for manoeuvre;[25] and

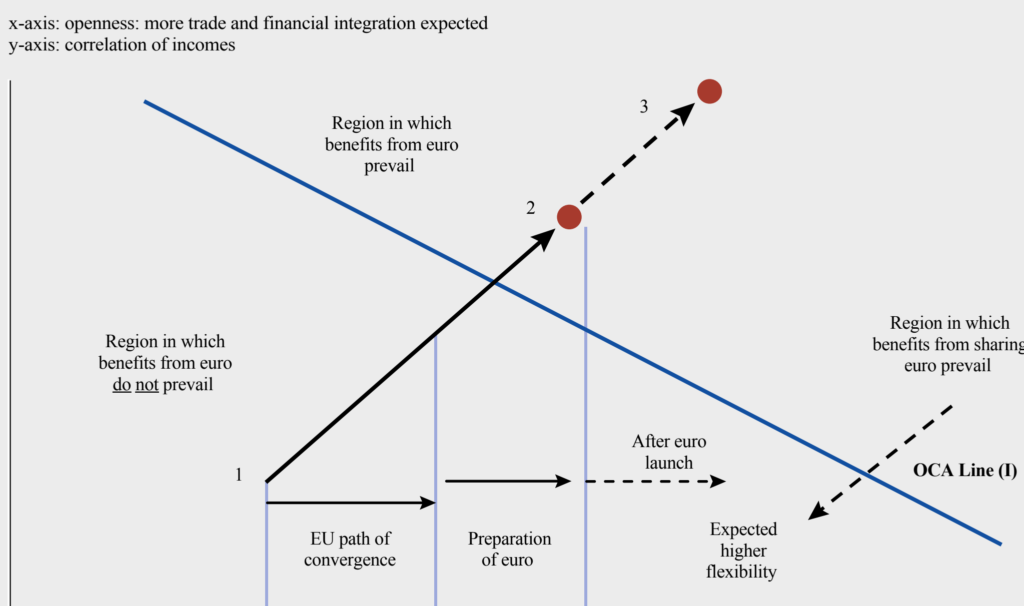
- *"correlated"* with each other. This implies the absence of persistent and irremediable divergence over the medium to long term. While some heterogeneity is normal for any monetary union, a lack of convergence over time may be problematic (ECB (2012c)). There is a need for self-correction over longer periods of time. Real correlation is promoted by low and similar inflation rates, highly diversified production and consumption diluting the possible impact of country-specific shocks, high openness and flexibility, and by broadly similar policy preferences.

Why launch the euro in the first place? The reasons lie in the net benefits which the euro can bring over time. In normal times, euro area countries expect to gain from: improvements in microeconomic efficiency, such as from deeper trade and financial integration that boost competition, employment and growth; from improvements in macroeconomic stability, such as from low current and expected inflation and interest rates, from increasing risk-sharing through financial market integration; and from the international role of the euro and seigniorage gains resulting from other countries holding euros as reserves or hard currency for international transactions as well as lower international transaction costs (see ECB (2012d)). Moreover, greater openness and flexibility reduce the costs of losing direct control over domestic monetary policy and national exchange rates. A lesson from the crisis is that the net benefits from the euro also hinge on the solidity of EMU's political economy and national governance. And if a financial crisis or an adverse shock does occur, the "architecture" should permit it to be managed and resolved with as little contagion as possible.

From an OCA perspective, how did the three fault lines and the failings in EMU's political economy affect the euro area? This illustrative framework was originally put forward by Frenkel some years

25 Conversely, high public deficits and/or debt reduce flexibility: a concept that goes beyond nominal wage-setting, as it can draw on various mechanisms and channels to enhance efficiency and facilitate the adjustment in response to a shock. Openness and flexibility can move in different directions. The US has been a fairly high-productivity growth country, but relatively closed, as Japan was for a long time, until 1990 at least. A country like Belgium has seen pretty slow productivity growth but is very open indeed.

Chart 3 Expected benefits from the euro

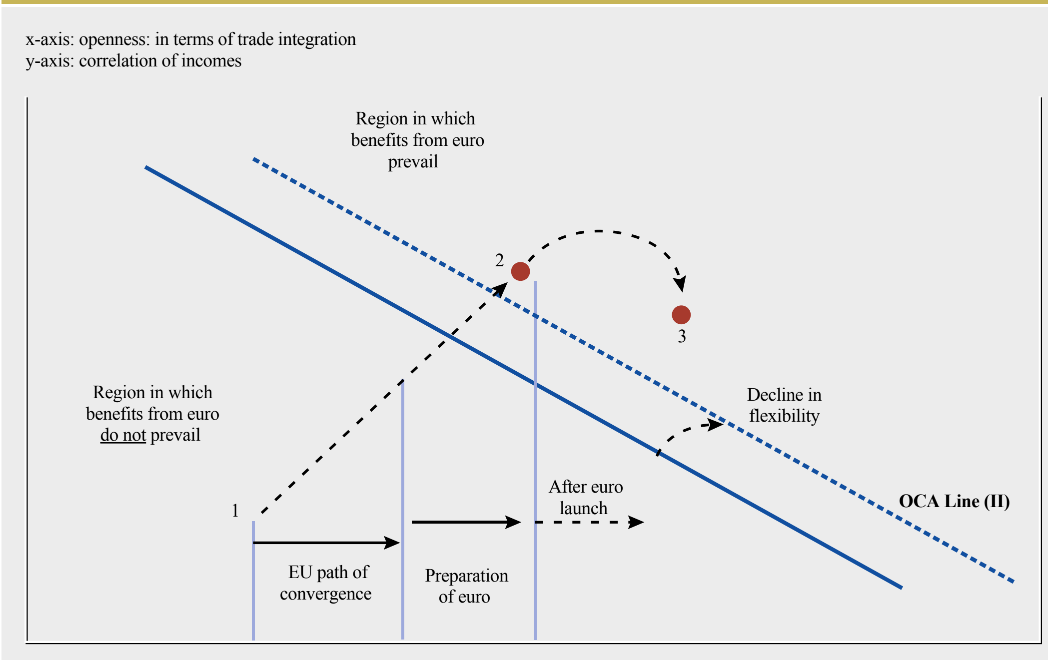


ago (see also De Grauwe (2012)). The pre-crisis scenario is explained first. *Chart 3* plots various combinations of openness and income correlation among euro area countries. For points on the right and above the "OCA line" the benefits from the euro prevail (Mongelli (2010a)). This implies that openness and flexibility are high, and the Single Market is working well, and that euro area countries exhibit similar cycles. An increase in flexibility shifts the OCA line downwards, raising the benefits from the euro. *How about the single monetary policy?* Greater openness, flexibility and income correlation spur further economic convergence and ease the implementation – and transmission – of the single monetary policy that is set by the ECB. *Ceteris paribus*, the achievements of the first decade of the euro are captured by the shift from point 2 to 3 and an increase in benefits.

How about euro area imbalances? Persistent budget deficits (e.g. Greece and Portugal) and sustained high indebtedness (e.g. Italy and Greece) have pushed flexibility down. Also, the financial turmoil and the Great Recession following Lehman's bankruptcy have weakened euro area economies further, and worsened budget deficits and debt ratios, as a result of the need to support the financial system and let the automatic stabilisers work. This has hampered income correlation.

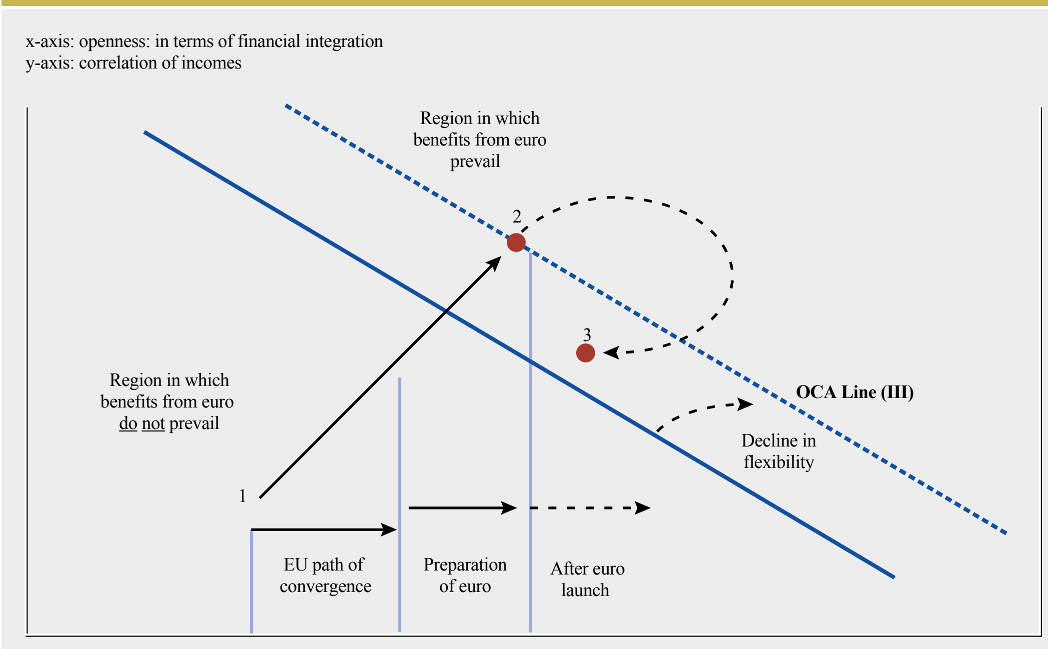
The high and persistent current account deficits in various euro area countries, e.g. Ireland and Spain, following the prolonged credit boom and financial inflows, brought a rapid decline in openness and income correlation. These growing and persistent imbalances are illustrated by a shift outwards of the OCA Line in both *Charts 4 and 5*. Slow productivity growth in various other euro area countries and persistent heterogeneity, e.g. in GDP growth, employment and labour market participation, also reduce income correlation within the euro area and hamper flexibility and openness (as both banks and companies may retrench domestically and imports decline). A difference between these two figures is that in Chart 4 the slight increase in trade integration partly compensates for the decline in income correlation, while the increase in financial integration has undesired effects and actually further reduces flexibility.

Chart 4 Effects of euro: trade integration



How about the global financial crisis and the sovereign debt crisis? The global financial crisis – with drying up of money markets, seizures of large banking groups, spreading uncertainties and rapid contagion, and so on – exacerbated these adverse dynamics for the sharing of the euro. Things

Chart 5 Effects of euro: "poor" financial integration



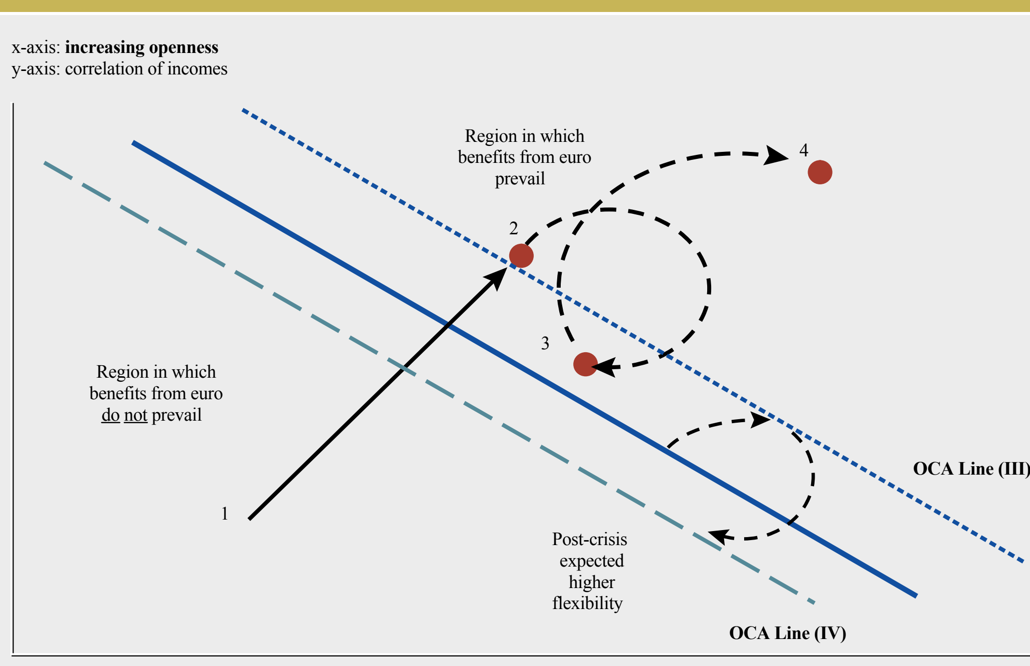
got worse during the most intense period of the sovereign debt crisis – from Spring 2010 till the Summer 2012- as shown by the adverse feedback loops (fiscal-financial linkages) in several euro area countries, i.e. CDS spreads for sovereigns and banks have been moving in parallel. Yield differentials of several euro area government bonds have grown further apart and have exceeded, in some cases, the levels preceding the launch of the euro. In terms of our model, this entails a weakening of flexibility and over time also income correlation. Hence the even lower positioning of Point 3 in Chart 5. The combination of all that went wrong during the first ten years of the euro is reducing the net benefits of the single currency in the medium to long term (at least until the adjustment is completed).

What is the impact of the new EU/euro area governance framework? In terms of our chart, the new political economy of EMU, including the economic governance framework, i.e. the "Six-pack", plus the forthcoming "Two-pack" and the Fiscal Compact, will push the euro area towards a higher combination of income correlation and even financial links and trade openness by preventing protectionism and reversing heterogeneity (i.e. towards *point 4* on *Chart 6*). Over time, structural reforms, a banking union, coupled with a fiscal union, could enhance flexibility and openness and drive up income correlation.

To sum up. The euro area is not an optimum currency area (OCA) like, for example, the US. This was a line of scepticism that was born with the euro, but lay dormant during the currency's first decade.[26] But we are now witnessing a profound transformation of the EU and euro area in

26 Although some are not sure that even the US might be a perfect OCA. For example, how much labour mobility is there between Alaska and Arkansas? Why did unemployment rise more in the US than Germany in the crisis? Moreover, European countries are more diversified than US states: i.e. they produce "a bit of everything" and are less exposed to sectoral shock.

Chart 6 Effects of euro: "poor" financial integration



particular. Deep economic, financial and institutional changes are under way and will take some time to display their effects. It is entirely possible that in a few years the euro area will score much higher than today under various OCA criteria, and will still be more diversified than US states and regions. Thus, EMU may become a different sort of viable OCA than the US and still be greatly beneficial for each member country. A crucial aspect is that within the euro area story there are national stories to boost domestic flexibility, openness and correlation.

7 TENSIONS BETWEEN "EMU ADVOCATES" AND "EMU SCEPTICS"

Can the various strands of this discussion be drawn together? Euro area countries have learned the lessons from the ongoing crisis, singularly and collectively. They have witnessed the seizing-up of financial markets, a sharp drop in trade, rapid economic contraction and surges in unemployment, soaring indebtedness, troubled banks, impaired monetary transmission, increasing social inequalities, and so forth. The ECB and the Eurosystem are implementing exceptional monetary measures, some of which are non-standard (Drudi et al. (2012)). At national level, resources are being moved from welfare and growth to underpinning the domestic financial system. This creates resentment among the public of stressed countries. Conversely, the public in the creditor countries of the euro area – who feel they are bailing out the "undisciplined partners" by backing the new financing facilities (EFSF/ESM) – is also resentful, and this situation polarises the political debate. At the risk of oversimplifying two scenarios are unfolding.

7.1 THE VIRTUOUS – BUT STILL VERY TOUGH – SCENARIO

The ***"virtuous scenario"*** is a story of transformation and adjustment. National fiscal consolidation plans as well as product and labour market reforms are now under way in all countries. Persistence and time are needed to display the beneficial effects of these measures and to permit the reinvention of various economic sectors and activities.[27] EU/euro area governance has been overhauled and a viable constitutional framework – with the four unions – is within reach (see Cœuré (2012)). The risk-sharing mechanisms, previously discussed, are now now at work: they are granting some limited mutual insurance (and a chance to fight the crisis).

However, an increasing number of people believe that a ***second "unstable scenario"*** has been unfolding. What drives such pessimistic views? Many critics of policy responses claim that continuing fiscal consolidation and structural reforms can weaken economic activity in the short term, which in turn might worsen public finances and financial conditions. Some critics go even further and warn that *too much too soon* is being expected from the stressed debtor countries, while creditor countries simultaneously pursue a counterproductive fiscal consolidation. The result of this policy mix is recession in the stressed countries, with extremely high unemployment (particularly youth unemployment); and probably a similar contraction in the "core" countries as well.

There can be multiple equilibria and self-fulfilling prophecies. If enough commentators and market participants start doubting the strength of the adjustment and of the underlying debt sustainability, this might erode confidence and widen spreads, rendering debt issuance more costly. Over time, banks burdened with sovereigns and struggling loans follow suit, enhancing the risks of a credit crunch and/or the need for recapitalisation. Hence, the risk of financial instability and hence the demand for ever greater firewalls, backstops, financing facilities and resolution framework. Bailout risk rises, as do risks of social explosions, forced exits, contagion, etc. in this scenario. The **crisis is then paid for twice:** when it first hits and after the remedies are perceived as counterproductive by many, thus causing even larger losses. In this scenario the risks of fiscal and/or financial dominance soar. *What else could be done?*

27 For example, the Hartz IV labour market reforms that Germany undertook about eight years ago only bore fruit after several years.

7.2 ARE WE CORNERED? STATEHOOD VERSUS A "QUASI-CONSTITUTION"

The steps taken towards the new EMU of the last 24 to 36 months have been very significant. But trust seems to be slipping away and financial market pressure on many euro area countries is unrelenting, and several economies are now severely weakened. Some market participants, such as Mohamed El-Erian and George Soros, as well as various commentators, including Martin Wolf (FT), are setting deadlines and expiry dates for the euro area as we know it. They are calling for a rapid *corner solution*, such as a full European state with debt mutualisation and changes to the mandate of the ECB to allow it to act as a lender of last resort for sovereigns.[28]

At the moment, such a solution would neither be feasible nor acceptable to most national constituencies, and particularly those now providing the AAA/AA/A-rated guarantees underpinning the EFSF/ESM. It may even erode their political support for and goodwill in respect of implementing EMU's new constitutional framework and strengthening its political economy. Moreover, the three imbalances which have contributed to the sovereign debt crisis would still need to be resolved beforehand. Otherwise, there is a risk that a stream of cross- country transfers akin to those already taking place within some countries (*Mezzogiorno* of Italy or Germany's *Bundesländer*) might become permanent in Europe. There is **fear of a "transfer union"**.[29]

7.3 OPERATING NOW WITHIN BOUNDARIES

The euro area is not likely to become a federal state in the traditional sense of the term in the near future. Neither can it remain as it is now. Commentators, EMU sceptics, critics and ultimately market forces are targeting several countries – including Germany – and demanding a corner solution, including a high degree of debt mutualisation, more substantive internal transfers and "locomotive-type policies". In most euro area countries this is not politically feasible. It would also represent a failure to learn the lessons of the crisis: i.e., about the need to boost flexibility, openness and income correlation. It is an indefensible position for many European/euro area policy-makers. Yet, even setting aside European statehood for the time being, no euro area country will ever want to be plunged into such a crisis again. The economic, financial and social costs have been enormous. The "four unions" once completed and transposed into national law, represent EMU's quasi "constitutional framework" to foster a viable and sustainable euro area.

7.4 BUT WILL THE EU/EURO AREA'S NEW POLITICAL ECONOMY SUFFICE?

Not really, and why not? Because there is a dimension of the crisis that remains supremely national: namely, finding a consensus on, and support for, new social contracts among national constituencies, and choosing sustainable national covenants. This requires tough choices across generational divides and over time: e.g. improving education versus delaying pension entitlements, infrastructures versus healthcare, research and development versus defence, and so on. Strengthening of tax administrations and treasury systems, expenditure control, privatization and divestments will also be crucial (e.g. in Greece and Italy). Reducing the costs of doing business, e.g. the "bureaucracy and red-tape costs" will matter more than ever. Thus, each country needs to find its own trade-offs – and support from its national constituencies.

28 For a reasoned proposal see Collignon (2005).

29 Inter-regional transfers take place in Canada and the US. Some see it as the price of a political project which is nonetheless pursued because the overall benefits still exceed the costs. Yet, the EU/euro area is not a federal state and its budget is extremely small. This is clearly a topic that goes beyond the scope of this paper.

There is also a need to activate the competitiveness channels. How? By checking that the overall costs of production do not stray with respect to the main partner countries and competitors, by monitoring export market shares, by promoting innovation and productivity, and so on. There is no single approach.[30] Potential growth and employment could also be supported by the Growth Pact discussed at various EU summits. It is feasible in a short time span. It entails directing EU funds to finance networks and projects of joint interest in low-competition sectors which would help generate public goods for Europe, such as cheaper energy, better pan-European transport-gas-electricity infrastructures, cheaper communication networks, and so on. Moreover, there is a need for true innovation à-la-"Silicon Valley", investment in scientific and technical education, research and development, encouraging "angel investments" and "venture capital", and so on.[31]

Point 10. Such "holistic" national therapies are inescapable: without them no change in EMU's political economy and governance, or financing facility can be sustainable in the long term. The "national ways" will move the whole euro area outwards in terms of openness, flexibility and income correlation. Various critics note that overall demand appears to be deficient in Europe/the euro area: therefore, large-scale public projects should complement the above supply-side reforms. Hence, in the coming years we might see a contrast between the "decline hypothesis" postulated in the IMF's latest WEO (IMF (2012)) and the growth enhancing effects of reforms.

30 Regarding the complexities of defining, capturing and regaining competitiveness, see Altomonte et al. (2012), Del Gatto et al. (2012)), Collignon (2012), and Münchau (2012). The Swedish economist Lars Calmfors has shown that real wage dynamics can favour competitiveness, and foster growth and employment, under two extreme wage bargaining models: either through national income policies which entail social pacts among governments, and associations representing respectively employers and employees (i.e. trilateral agreements); or through decentralised bargaining arrangements (industry to industry, sector to sector, or even plant to plant) (see Duval et al (2006)).

31 This is a non-linear process that requires nurturing and time to help the new drivers of growth in the crisis countries. After all, aren't many Europeans successful in Silicon Valley as well?

8 SOME FINAL POINTS

The sovereign debt crisis has been a traumatic event in the still short history of the euro area. This paper has shown that it cannot be interpreted as a unified phenomenon: the crisis is in fact a hybrid of several harmful factors that are distinct but interlinked. The lessons were many and painful. There were gaps in EMU's institutional framework and fissures in the supranational and national governance: moral hazard build-up. Thus, lack of genuine political integration entails systemic risks. Looking ahead, within the evolution of euro area institutions and political economy, there must also be national ways to enhance flexibility and openness, and to secure correlation with partner countries (by boosting innovation, productivity, growth and employment where needed). Thus, prosperity in an economic and monetary union is a collective and national responsibility as well as opportunity.[32]

This paper has given expression to some thoughts on several dimensions of the sovereign debt crisis of the euro area, but without offering a coherent and conclusive view. Several points have been raised along the way and here are some additional ones.

Point 11. There is a "confirmation bias". Over the last two and a half years there has also been a steady erosion of trust in, and public support, for EMU. Several commentators - including Soros (2012 a and b), Martin Wolf (2012) and Nouriel Roubini (RGE Monitor) – have doubts about the integrity of the euro area as we know it today: see also Bergsten and Kirkegaard (2012)) and Baldwin (2012). They doubt that the daunting adjustment programmes can be completed in all countries. There are concerns about a possible irreversible economic stagnation of most of the euro area, or even a permanent decline that may be followed by financial meltdown in some countries (Deutsche Bank (2013)).

Point 12. Yet, all dimensions of the crisis have been addressed. Several financial risks have started receding since last Summer. Perceptions about the euro area are slowly improving, and funding conditions are easing. All indications are that adjustment programmes are achieving their targets in Ireland and Portugal and some progress has also been made in Greece, while Spain is benefiting from more targeted assistance. Serious national reform efforts have started in all other stressed countries as well. The effects of "internal devaluations" are gradually becoming visible with a significant rebound in their exports and a narrowing of current account deficits (Goldman Sachs (2013)). This creates a window of opportunity for consolidating the "genuine political integration" that is in sight: i.e., the fiscal union for fiscal stability and to face public finance challenges, banking union for financial stability, economic union to support reforms and growth, and political union for democratic legitimacy ("4-Unions"). The 'old' EMU is changing into a 'new' EMU (Mongelli and van Riet (2013)). Still, the path out of the crisis will be strewn with obstacles and execution challenges.

Point 13. Complacency and backtracking are now the risks. The euro area is facing a **challenge of transition**: it will take some time to see a full display of the new fiscal and economic governance. It is also facing formidable **implementation challenges**. The financial system is still deleveraging, recapitalising and adapting to the new regulatory and supervisory environment, which is itself tightening further in response to the crisis and to reduce future systemic risks. Therefore, credit conditions are likely to remain tight. Fiscal consolidation is being pursued at a pace that does not

32 Plus there are the lessons from the global financial crisis per se, the taming of moral hazard in financial institutions, the resetting of incentives for financial market participants, the tightening of financial regulations and supervision, Basel III, the vigilance of systemic risks and so on: but these were not the topic of this paper.

choke off the economy, yet is effective and credible. Is there also a **"transposition challenge"**? Experience in Spain and Italy shows how important it would be to transpose the euro area's new political economy also at sub-national level, think of Italian and Spanish regions and provinces, and also across welfare systems (like pension, healthcare and long-term care).

Point 14. There is also a challenge of legitimacy and acceptance. Clearer rules that are measurable, enforceable and similar for all levels of governance – i.e. European, national, regional and even provincial – could gain the public's understanding and support. This might generate more scrutiny, and possibly participation in policy debates: e.g., when confronted with specific choices and trade-off. Political institutions – supranational, national and sub-national – must become more transparent and inclusive (Acemoglu and Robinson (2012)), and Hallenberger et al (2012)). Such political ownership can help reducing credit spreads and ease the adjustment process. While we are making progress on this dimension, the "European way" still seems always more complex (Wyplosz (2013)). *Can anything more be tried?*

Point 15. There is still the "elephant in the room". Euro area countries are, at least temporarily, more heterogeneous. As a result of the fault lines and the crisis, they have diverged. Some euro area countries have lost significant manufacturing activities and are less differentiated now in terms of manufacturing: they have to reinvent part of their economies. Thus, a neglected aspect, in the current euro area crisis is that sometimes temporary transfers and shared cross-country projects, when coupled with disciplined domestic reforms and rebuilding of national governance, are essential to turn around a deep economic crisis with depressed demand, rundown supply-sides, high unemployment, and deep social malaise. The newly proposed Growth Pact goes in this direction. Moreover, even though it was in a very different context, the Marshall Plan can be considered as an example of such a process. Investment in strategic network industries might also help. Sceptics may fear that big pan-European projects may be costly and inefficient, and more joint funding will simply entail moral hazard and even boost the dependency of the recipient countries: thus the risks of a "permanent transfer union". But it would be one of the main tasks of EMU's new political economy to put up defences against such moral hazard.

Point 16. Fear of a meltdown and the will to survive are powerful motivators for financial deleveraging, balance sheet adjustments, and for structural reforms: they are certainly contributing to the radical transformation along all crisis dimensions now underway. However, in the long term, the integrity of the euro area – and also its prosperity – must be founded on its intrinsic values, for example, as a catalyst for a stronger single market, as a catalyst for deeper (and sound) economic and financial integration, and because of its long-term benefits.[33] In many ways the factors that led to the launch of the euro are still valid, and the crisis we are in is not a monetary crisis. The euro can provide a shield from outside shocks, reap the benefits of being a credible world currency and foster internal stability. There are still countries which wish to adopt the euro in the coming years and the international role of the euro remains strong (ECB (2012d)).

Point 17. From short-term stabilisation to some long-term feasible vision. The renewed stability of the euro, and EMU's new political economy, can also support a redrawing of the global financial architecture, ease the coordination among regulatory and supervisory frameworks (thus

33 Financial integration can represent a more important insurance mechanism than a federal budget. For example, Asdrubali et al (1996) looked at channels of interstate risk sharing in the US. They focused on shocks to gross state product and found that 39% of the shocks were smoothed through capital markets, 23% are smoothed through credit markets and 13% through the federal government. 25% are not smoothed. Thus US financial markets contribute with 62% to the absorption of state idiosyncratic shocks. The effect is five times more important than that of the US Federal Budget.

reducing global systemic risks), remedy the global imbalances (that are still present), counter the "decline hypothesis" for advanced economies (IMF (2012)), and even address several geopolitical challenges that would be "too big to address" for any European country alone. Such elements of a future vision may anchor longer-term expectations and ease the sharing of sovereignty that comes with the new EMU and the higher degree of centralisation now required. Such common goods can help overcome the cultural barriers.

Point 18. The euro area can become a viable optimum currency area (OCA) and be greatly beneficial for each euro area country. In a few years it will score higher than today under various OCA criteria – i.e., each euro area country can become more flexible, adaptable to economic shocks, open and remain correlated with the partner countries – and will still be more diversified than US States. In other words, today's stressed euro area countries can revive their productive sectors, innovate, and tackle their high (youth) unemployment and inequalities. At the same time, the euro area will be different from the US: one key difference will be that the EU – and thus the euro area - will not have a federal budget like that in the US. The current EU budget is likely to remain small and serve mostly community tasks and thus not risk sharing purposes. This has some disadvantages, but also advantages (fewer political frictions). Instead, there will be shared firewalls and fire brigades. A crisis management framework for euro area sovereigns and banks – and thus conditional and limited financial backstops – will originate from the European Stability Mechanism (ESM) and the working of the Banking Union: i.e., joint supervision (SSM), banking resolution, and deposit insurance schemes (once working).

Some shared housekeeping values are also emerging from the crisis: perhaps even elements of a common European culture that go beyond the Ryder Cup – a golf competition between leading European and US golfers – and various other European sporting championships and singing events (all successful). The balance between "EMU sceptics" and "EMU advocates" may then slowly change. The rest will follow.

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