

Athens University of Economics and Business



Managing the crisis of Eurozone

Reforms and Governance towards the resolution

Master Thesis




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December 2012

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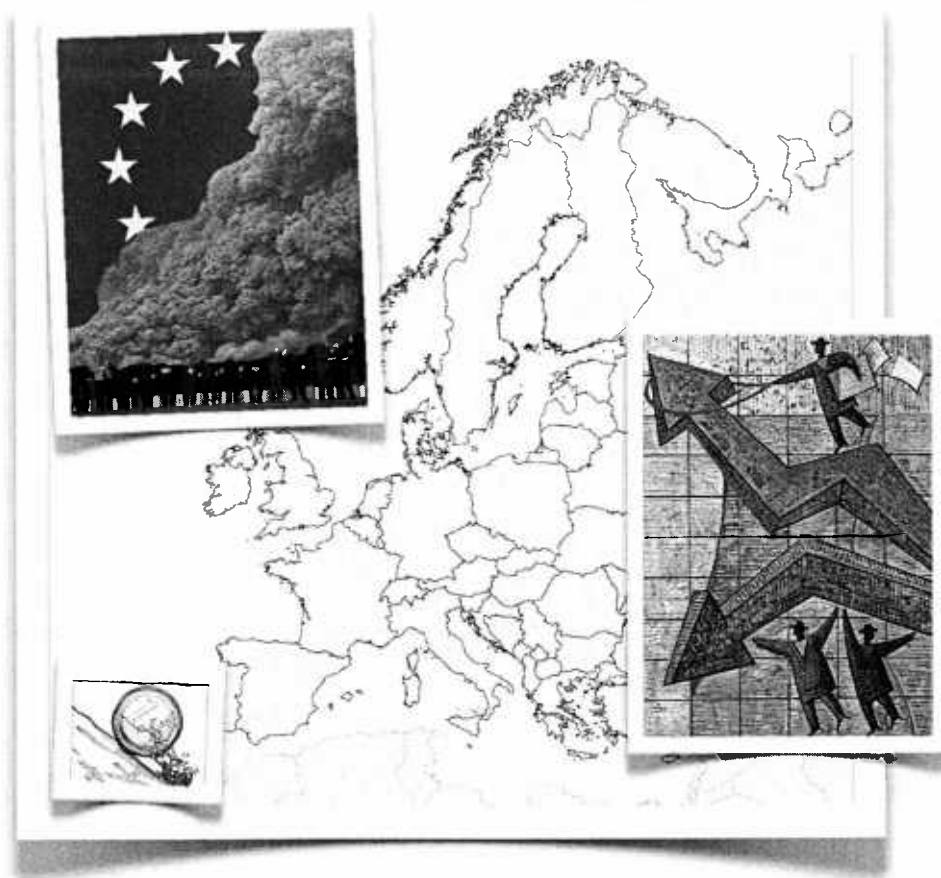


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Master Thesis

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Christiana Saranti



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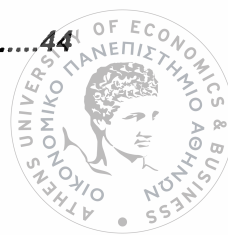


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Introduction

The crisis has challenged the foundations of the European Union. During the last years the changes in EU have been significant for its future. The Eurozone's capacity to deal with the deepest financial crisis since the Great Depression is being tested and its survival depends on the current decisions. The financial coherence of EU is put into question and the fragmentation is a real threat and closer than ever. Behind all this, there is a complex structure that despite the many years from its creation, now is a crucial moment for its final form. Institutions and individuals play important roles in this, but European citizens should and will be the last to judge and decide. At the time being, it is necessary to manage to pass through the recession period and confront the European crisis which undermines the political credibility of European integration. Eurozone should manage to establish a stable union, able to increase the welfare of its citizens, the accountability to them and to regain growth – something that at the moment seems hard to achieve.

After 2008, time has been revealing weak points in the financial and fiscal structure of the Union, urging for changes. The policy makers and the academic community have been alert. Macroprudential policies, structural reforms and the creation of new bodies became the keys of action in Eurozone in order to mitigate the risk of the financial system and pursue financial stability¹.

Lessons obtained from this crisis are a lot: strong interdependence between features of financial system, shortcomings in the structure of EU, mistakes, fears, political power, priorities, need of solidarity and many others. Hopefully they will be used to establish a strong future union with the appropriate governance institutions.

The monetary union deprived the countries of economic policy instruments and the option to issue debt. In the case that investors loose trust on one country, they sell government bonds raising the interest rate and invest to another country taking the liquidity from the first. The increased interest rates show bigger risk for the bonds and soon this country will face liquidity crisis that can force the government into default. The market power in a union is very strong. Market expectations in a self-fulfilling way can lead to default. The stabilization of the economic cycle becomes impossible².

¹ Veron N. (2012) "Financial reform after crisis: An early assessment" BRUEGEL, January

² De Grauwe P. Yuemei Ji Licos (2012), "Mispricing of sovereign risk and multiple equilibria in the Eurozone" University of Leuven and CEPS, January



The monetary union does not allow the automatic stabilizers (taxes, welfare benefits) to work, creating social problems and difficulties to many people.

The governance structure should protect the stabilizers, improve coordination and deal with externalities that are the results of contagion. Systemic features cannot be solved by punishments and austerity programs but by mutual support, control and coordination. The financial crisis is far from over but it is left to see if it will lead to stable coherent union or not³.

In this thesis, in the first chapter there is a description of Europe's response to the crisis since it erupted and their shortcomings. After that there is a presentation of potential steps and policies that could be launched in order to improve the current situation in the fields of economic policy and governance in the Eurozone. Chapter 2 is about European Imbalances and divergences and how to deal with them. Chapter 3 is about Fiscal union, its necessity, its different elements and how to approach them. Chapter 4 is about the Banking union, how it is crucial in order to move from the crisis and what it can include. On the last chapter there are some concerns about the democratic legitimacy of procedures in Europe.

³De Grauwe P. (2011) "The Governance of a fragile Eurozone", University of Leuven, CEPS, April



1. Responses to the crisis

As the crisis was spreading in European Union, several mechanisms and measures were set up in order to face the problem and steps were taken towards the resolution. However, nothing could stop the fast transformation of the economic crisis into a sovereign debt crisis and the contagion around EMU. It became clear that EMU was an imperfect, unsteady union with slow reactions to threats.

To begin with, in 2009 it was already clear that governance was weak, there was no crisis resolution mechanism and surveillance of macroeconomic imbalances between member states was poor⁴. These imbalances were ignored, leading to growing surpluses on the north and deficits on the south, caused by imports, exports and loans. EU was systemically underestimating the imbalances arguing that external deficit is of minor importance in a union. Banking supervision was inadequate and ECB inactive, deteriorating the imbalances. The main instrument of ECB was the short-term interest rates, but it was the long-term rates on government bonds that increased the differences between member states through inflation rates. In addition, member states did not respect the Stability and Growth Pact objectives and no sanctions were imposed⁵.

European Union offered financial assistance to countries with highest levels of debt and imposed austerity measures. The European Central Bank introduced programs to purchase debt and provided some liquidity. Finally, some steps have been made to introduce structural reform and growth programs. However policy makers were acting ad-hoc and in slow pace because of complicated bureaucratic and institutional procedures. The contagion of crisis in Eurozone was not foreseen, bail-out of problematic countries was not allowed from the treaty and there was wrong belief that we had to face a liquidity crisis while sovereign crisis triggered banking crisis and cross country interdependence. Soon the once thought to be integrating union, turned into a number of separated, different countries-members of an unfinished Economic and Monetary union.

Euro area has a lot of problems and deficits. What stood out the most was the inability for decisive policies, and political decisions. All the weaknesses of the system actually became obvious with the beginning of an unsustainable private debt accumulation before crisis, that made

⁴ Pisani-Ferry J., Sapir A., Wolff G. (2012) "The messy rebuilding of Europe" BRUEGEL 30 March

⁵ Bastian J., Begg I., Fritz-Vannahme J. (2011) "Making the European Union work" Issues for Economic Governance Reform, Bertelsmann Stiftung, 3 March



governments intervene and increase their debt. The private debt was being developed with large divergence between member states, caused at one point by macroeconomic divergences.

The attempt to coordinate national fiscal policies in EMU with a rule and sanction-based framework called Stability and Growth Pact (it entered into force in 1999), failed being the result of an incomplete agreement incoherent with democracy⁶. The model of policy making that the SGP introduced, was giving decision power to individuals and institutions that do not face political sanctions by electorates. SGP demanded that each member state had to balance its structural deficit so that the ECB can achieve price stability and smooth the fluctuations. It tried to work as a convergence mechanism to coordinate national fiscal policies and to achieve monetary stability and long-term sustainability of public finances. However, it was difficult to be implemented due to political obstacles⁷. The SGP failed in 2003 when the Commission requested Germany to reduce its structural deficit by 1% of the GDP, and France by 0.7%⁸. This never happened, neither the imposition of a sanction⁹.

Most of the new regulations, making more difficult the distinction between euro area and EU management, made the decision-making system more complex and as result more difficult to manage and slower to produce results. The legal gap between euro area and EU countries became wider. This caused reasons for disagreements between countries that want to join and not, about the relation with the euro area and its decisions that affect the rest of EU through spillovers¹⁰.

The EU policy framework for crisis management was mainly based on the existing institutions, but some actions and procedures were introduced. In 2010 it was already clear that the intervention of the European Central Bank (ECB) in the European crisis, being the monetary policy maker of EMU, was inevitable. However, bound by the Lisbon Treaty the ECB was an independent institution focused on monetary policy and completely detached from the fiscal policies. Having as main goal the maintenance of price stability, the ECB was not allowed to buy directly treasury

⁶ Paul De Grauwe (2010), "What kind of governance for the Eurozone?" No. 214/September CEPS

⁷ Collignon S. (2004), "The End of the Stability and Growth Pact?" International Economics and Economic Policy CEP Volume 1, No1, January

⁸ The European Council (2003), Economic and Financial Affairs, Press 320, 25 November
http://europa.eu/rapid/press-release_PRES-03-320_en.htm?locale=en

⁹ "The Commission takes note of the rejection by the Council of the Commission recommendation under Article 104(8) for France and Germany, without giving the adequate explanation...The Commission deeply regrets that the Council has not followed the spirit and the rules of the Treaty and the Stability and Growth Pact that were agreed unanimously by all Member States. Only a rule-based system can guarantee that commitments are enforced and that all Member States are treated equally." The European Council (2003), Press 320, 25 November

¹⁰ Veron N., (2011) "Testimony on the European debt an financial crisis" BRUEGEL, September



bonds from sovereign debtors in order to give breath to the markets, as this would trigger worries about moral hazard among the governments of the member states of EU. Consequently, the governing council of ECB introduced a temporary program to purchase public and private debt securities from the euro-area countries on the secondary markets.

Objective of this program was 'to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism'¹¹.

Even if technically the ECB did not break the rule of the Treaty, it actually intervened in matters deferent from price stability, and in fiscal activities. Introduction of an indirect bailing out mechanism for insolvent banks and debtors by the ECB highlighted the absence of such a mechanism and its necessity. In the same year, the European Council with a statement¹² commits to strengthen the coordination of economic policies and to find ways to improve the economic governance in EMU with the use of a task force. They realized the need of action for fiscal sustainability and the need of a framework for dealing with crises with increased coordination, surveillance and prevention of risks.

1.1 Coordination of national policies- The European Semester

Response to this statement was the proposal of the Commission to introduce the European Semester. It focuses on national fiscal policies and reform strategies, on macroeconomic imbalances, on financial sector, on budgetary processes and on the way to coordinate them in EU level. It starts with an annual growth survey and provision of guidance and recommendations from the Commission to the member states¹³. Then, the member states form the National Reform Programs (NRP) and the Stability and Convergence programs (SCP). At the end, the "country-specific recommendations" from the European Council and ECOFIN are adopted, so that Member States have policies and priorities that do not oppose to the objectives and policies of EU, when preparing their budgets¹⁴.

¹¹ ECB press release 10 May 2010 - ECB decides on measures to address severe tensions in financial markets

¹² The European Council (2010) "Statement by the Heads of State and Government of the euro area", 25 March http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113563.pdf

¹³ The European Commission "EU economic governance-Coordination of economic and fiscal policy planning - The European semester" http://ec.europa.eu/economy_finance/economic_governance/index_en.htm

¹⁴ "European semester: a new architecture for the new EU Economic governance – Q&A" 12 January 2011 http://europa.eu/rapid/press-release_MEMO-11-14_en.htm



What went wrong? The European Semester firstly raised questions about the democratic legitimacy of governance¹⁵. Commission's recommendations happened to be altered by the EU Council, while EU Parliament as much as national parliaments are less involved (e.g. member states that receive financial assistance follow policies agreed in EU level insignificant).

Secondly, member states do not always implement the policy recommendations. The Commission cannot enforce the decisions due to the lack of binding regulation.

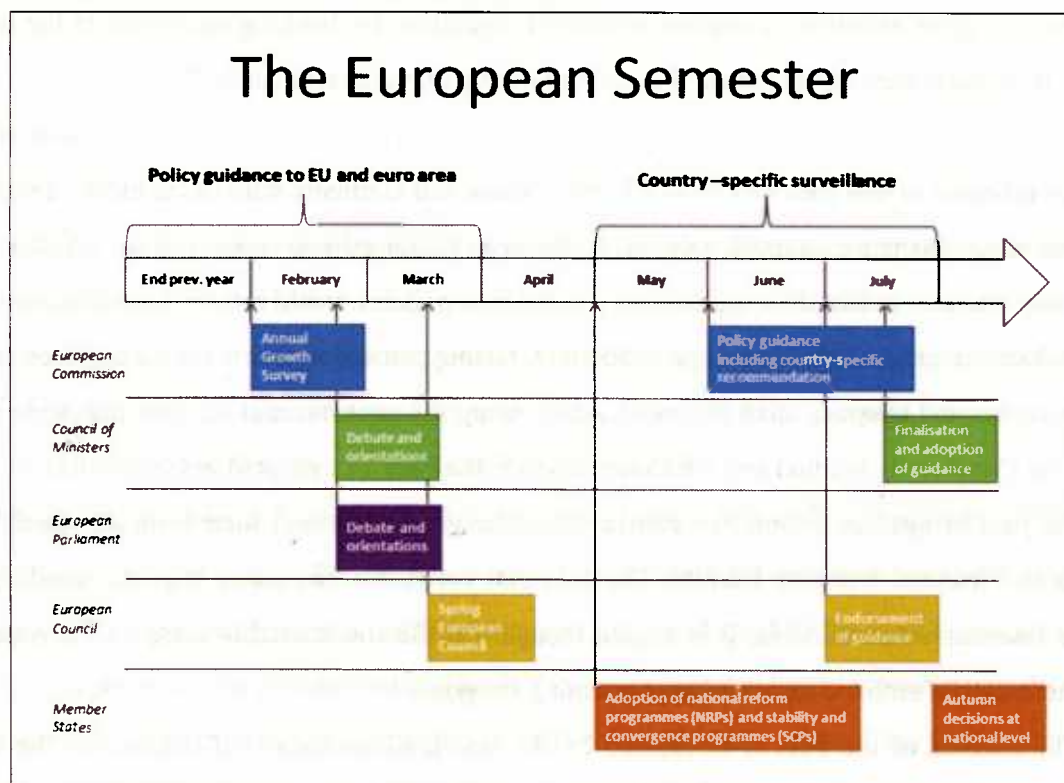
The European Semester would be actually effective if it would manage to address spillovers between the member states and implement policies that could improve the current situation in EMU. The recommendations fell short of the objectives. One example is the failure, or better the tense to avoid dealing with the current account surplus of Germany which is a big economy and its situation significantly affects the stability in euro area. Instead, the recommendations to Germany were focusing on other aspects of the economy that would not offer much to address the existing recession. The recommendations, while trying to be beneficiary for the individual member states and the euro area, were missing the target¹⁶.

Even though it became obvious that the coordination recommendations on the budgets are necessary and that the Commission strengthened its positions, political influence by ECOFIN was also significant. Consequently the European Semester did not justify the reason of its creation.

¹⁵ Hallerberg, M., B. Marzinotto and G. Wolff (2012) 'On the effectiveness and legitimacy of EU economic policies', ISSUE 2012/04, Bruegel, November, <http://www.bruegel.org/publications/publication-detail/publication/758-on-the-effectiveness-and-legitimacy-of-eu-economic-policies>

¹⁶ Hallerberg, M., B. Marzinotto and G. Wolff (2012), "An Assessment of the European Semester", Bruegel, September <http://www.bruegel.org/publications/publication-detail/publication/751-an-assessment-of-the-european-semester/>

Figure 1: The European Semester



Source: http://ec.europa.eu/economy_finance/economic_governance/index_en.htm

1.2 Economic priorities - The Euro + Pact

The Euro Plus Pact (Competitiveness Pact) was integrated into the European semester and has the following goals:

- Foster competitiveness

It is implemented by focusing on cost of labor and productivity.

- Foster employment

It focuses on promoting “flexicurity”¹⁷, reducing undeclared work and increasing labor participation. It includes actions for lifelong learning and tax reforms.

- Contribute further to the sustainability of public finances

This goal insures sustainability of pensions, health care and social benefits by reforming national systems and fiscal rules.

¹⁷ 'Flexicurity is an integrated strategy for enhancing, at the same time, flexibility and security in the labour market. It attempts to reconcile employers' need for a flexible workforce with workers' need for security – confidence that they will not face long periods of unemployment.' The European Commission
<http://ec.europa.eu/social/main.jsp?catId=102&langId=en>

· Reinforce financial stability

This reform gives attention to implementation of regulation for banking resolution in the member states. It includes bank stress tests and close monitoring of national situation¹⁸.

The proposal of this pact was initiated from France and Germany with much more controversial reforms about changing national policies. It has been criticized and rejected from member states. The main reason was that the original plan and the new policies would reform areas that were under national sovereignty (abolishing wage indexation, raising pension ages, creating a common base for corporate tax and adopting debt brakes)¹⁹. After losing the controversial reforms that were putting aside the Community method and the Commission²⁰, the Pact was adopted in March 2011.

The pact brings conditions like restructuring the greek debt and increasing the funds of the European Financial Stability Facility. The financial assistance can come with the condition that public finances are sustainable. It is argued though that the conditionality stays on the papers and that there are not outlined means of implementing the goals²¹.

The success of the Pact is threatened by the non implementation of reforms or the lack of support by the citizens of the member states. It should not be neglected that the Pact does not impose sanctions to noncompliant countries. Consequently, the euro plus pact can be considered as small and not certain movement towards the economic governance integration²².

¹⁸ The European Council (2011) "Conclusions of the Heads of State and Government of the euro area", 11 March http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/119810.pdf

¹⁹ Charlemagne(2010)"The divisiveness pact." The Economist, 18 October

²⁰ Euractive (2011) "MEPs angered by 'Franco-German approach'" EurActiv.com., 17 February <http://www.euractiv.com/future-eu/meps-angered-franco-german-appro-news-502231>

²¹ Gros D. (2011) "Pact for the euro: Tough talk, soft conditions?", VOX, 14 March

²² Barroso J (2011) "Taking stock of the Euro Plus Pact" Presentation to the European Council, 9 December http://ec.europa.eu/europe2020/pdf/euro_plus_pact_presentation_december_2011_en.pdf



1.3 Surveillance of economic and fiscal policies

1.3.1 Six-pack

Six-pack is a set of legislative measures. It contains five Regulations and one Directive. Four focus on fiscal policies: surveillance and coordination, excessive public deficit and budgetary surveillance. Two focus on macroeconomic imbalances. Six-pack reformed and strengthened the Stability and Growth Pact's preventive and corrective arm. It specified the accepted deviation from the medium term objectives²³ of the member states defined by SGP.

In addition, it activates the Excessive Deficit Procedure²⁴ when debt ratio is above 60% of GDP and not only according to deficit. Finally it increases the possibility for euro area member states to get a sanction, by introducing reverse qualified majority voting²⁵ (RQMV) for most sanctions and giving this way power to the Commission²⁶. The RQMV was supported by the Commission and the EU Parliament in order to avoid incidents like in 2003 when Germany ignored the Commission's decision.

The six-pack made fiscal surveillance stricter but increased the differences between euro area and non euro area countries²⁷. It moved power concerning national budgets of member states to the Commission but not their trust. The Council would have the final decision.

²³ 'Each Member State has a medium-term deficit objective for its budgetary position, defined in structural terms. The medium-term objectives differ between Member States: they are more stringent where the level of debt and estimated costs of an ageing population are higher.'

European Council (1997), Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, 7 July
http://europa.eu/legislation_summaries/economic_and_monetary_affairs/stability_and_growth_pact/125019_en.htm

²⁴ Deficit-to-GDP ratio of 3% and debt-to-GDP ratio of 60%.

²⁵ A recommendation or a proposal of the Commission is considered adopted in the Council unless a qualified majority of Member States votes against it.

²⁶ The European commission (2012) "Six-pack? Two-pack? Fiscal compact? A short guide to the new EU fiscal governance", 14 March
http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm

²⁷ Pisani-Ferry J., Sapir A., Wolff G. (2012) "The messy rebuilding of Europe" BRUEGEL 30 March



1.3.2 Treaty on Stability, Coordination and Governance (TSCG) – The Fiscal Compact

For the need of more coordination, fiscal framework and sanctions the TSCG was introduced and mainly affects the Euro area since it is binding only for euro area member states that signed it.

It includes the fiscal compact and changes in governance and policy coordination. The TSCG demands from the member states to converge to their medium-term objectives with limit of structural deficit 0.5% of GDP. The new regulations are to be implemented in the national laws. If not, European Court of Justice can impose a financial sanction of 0.1% of GDP to the member state. Sanctions would be channeled to the ESM. It also includes correction mechanisms and monitoring independent institutions²⁸. The TSCG was out of EU Treaty and was made with hope for achieving ‘growth and jobs’²⁹ like the other reforms – we can agree that this was not the case.

However, setting up the implementation of the rules was once again not foreseen and it was not binding for the member states that signed it (all countries of EU except the United Kingdom and the Czech Republic). The Commission and the Court of Justice (responsible for fining the countries not complying with the rules) do not have any authorization or any power to national policies.

As usually the national constitution has priority over an international treaty. It also gives no obligations to the non euro-area countries. As a result it is more a simple ‘political statement’ than it is a regulatory treaty³⁰. In reference to the contribution to the economic governance in the euro area, the Treaty simply established regular annual Euro Summits and increased the role of them and of the Eurogroup in drawing the directions of economic governance, always affecting the whole EU. Overall eventually ‘the treaty exposed the tension between national sovereignty and the logic of supranational intervention’³¹.

²⁸ The European Council (2012), “Treaty on Stability, Coordination and Governance signed”, 2 March <http://www.european-council.europa.eu/home-page/highlights/treaty-on-stability,-coordination-and-governance-signed?lang=en>

²⁹ “The restoration of confidence in the future of the Eurozone will lead to economic growth and jobs. This is our ultimate objective. The targets on deficits and debts are intermediate targets, no aim in itself.” Van Rompuy H. (2012) Speech during the signing ceremony of the Treaty on Stability, Coordination and Governance of the Economic and Monetary Union, European Council press, 3 March

³⁰ Gros D. (2012) “The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (aka Fiscal Compact)”, CEPS, 8 March

³¹ Pisani-Ferry J., Sapir A., Wolff G. (2012) “The messy rebuilding of Europe” BRUEGEL 30 March

Eventually the Treaty and the Fiscal Compact specifically, managed to promote tighter national fiscal frameworks; something that probably would have happened anyway in the member states because of market pressure.

The aim as mentioned before was to achieve the structural reforms that will correct their excessive deficit, but after adopting some fiscal rules in the national policies, the EU summits will be the remains of this treaty and their decisions will have to face national political realities.

1.3.3 Two-Pack

This measure consists of two regulations that intend to strengthen the surveillance mechanisms in the euro area for member states with financial stability difficulties and to introduce budgetary plans and deficit correction. Member States should submit draft budgetary plans, the Commission then analyses if the budget is made according to the SGP and the European Semester. If not, the Commission can ask for new draft budgetary plan³². However, national parliaments are the institution to vote for the Budget Law.

Euro-area member states with financial problems and those that receive assistance will be subject to surveillance. This means: measures to address the sources of the problems and inefficiencies, provision of data, technical assistance from the Commission if needed (task force) and financial consequences if the member state does not follow the plan.

1.4 Financial sector repair: Financial supervision and Assistance

The supervisory model that was created during the crisis was made for the whole EU. However, there are distinctions sometimes between euro area member states and non member states.

The European Systemic Risk Board (ESRB) “...shall be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability...”³³ It is financed by the

³² The European commission (2012) “Six-pack? Two-pack? Fiscal compact? A short guide to the new EU fiscal governance”, 14 March http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm

³³ Regulation (EU) No 1092/2010 of the European Council and the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board <http://www.esrb.europa.eu/about/background/html/index.en.html>



European Central Bank but makes macroprudential policy recommendations to euro-area countries taking into consideration the common monetary policy.

- The European Banking Authority (EBA) shall focus on “... stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors.”³⁴ (e.g. supervisory coordination, advice in the areas of banking, payments and e-money)
- The European Insurance and Occupational Pensions Authority (EIOPA) is an independent advisory body having as additional responsibility the protection of insurance and pension holders.
- The European Securities and Markets Authority (ESMA) is an independent authority that strengthens and promotes supervisory convergence, focusing on the protection of investors and security markets.

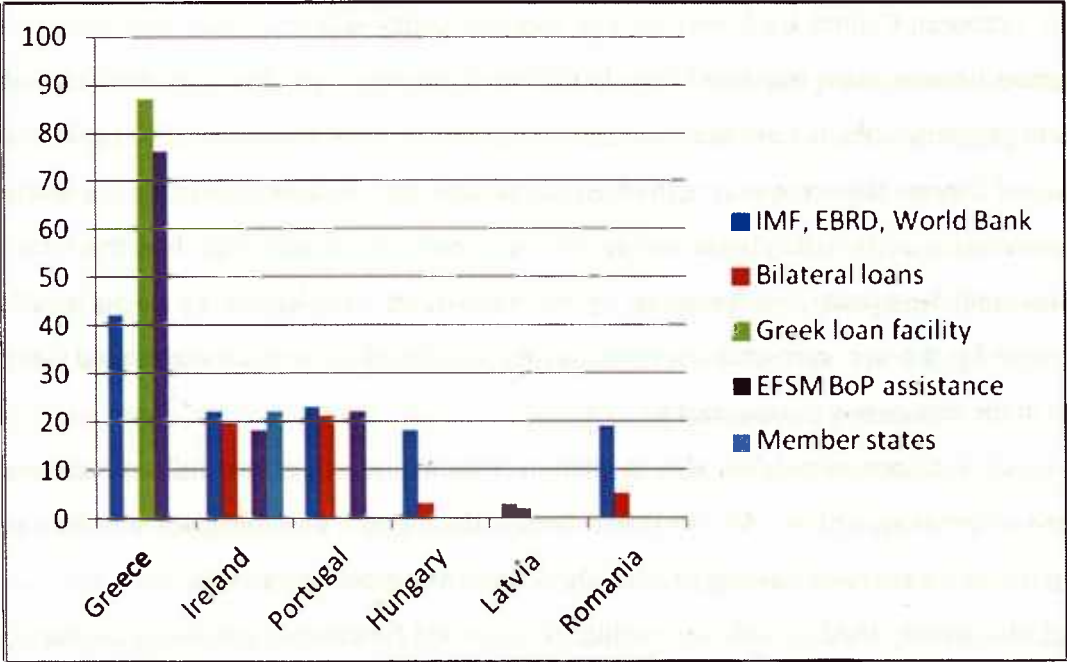
The financial assistance model was introduced and focused on the euro-area countries, even if assistance was not foreseen in the Lisbon Treaty. At the beginning there was temporarily use of a combination of different sources of assistance.

- The European Financial Stabilization Mechanism (EFSM) was used by providing loans from the Community budget.
- The European Financial Stability Facility (EFSF) provided loans in guarantees from the euro area Member States.
- Other instruments were: bilateral loans, several geometries between EMU members but also with participation of non euro-area countries³⁵, loans from International Monetary Fund (IMF).
- The European Stability Mechanism (ESM) is the permanent rescue mechanism for financing new programs. It was agreed that it is necessary and it entered into force in October 2012. It takes over the tasks of EFSF and EFSM. ESM is an instrument for euro- area countries that ratified the TSCG.

³⁴ Regulation (EU) No 1093/2010 of the European Council and the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority)

³⁵ Ireland received bilateral loans from the UK, Denmark and Sweden

Figure 2: Financial assistance in EU



Source: Bruegel

Figure 3: European Supervisory System



Source: ESRB

Source: ESRB

1.5 Leadership, decision-making and European Governance

The European Central Bank was the key and first policy-maker of economic governance. The Eurogroup became more important than ECOFIN. It was the main body for decisions about the different programs, like the private sector involvement, the labor market and the banking sector in the case of Greece. However, during the crisis, important decisions were taken by EU heads of state and government even if they were subject of the agenda of finance. This had the form of Euro Summits and the agenda was prepared by the Eurogroup. The legitimacy of such actions was questioned by the non euro-area countries, as the results of these decisions would have certain effects in the non euro-area countries as well.

A lot of decisions were taken also in intergovernmental meetings that followed the events and progress of previous actions. As mentioned before, the number of geometries was increasing and adding this to the decision-making process, the result was a practical muddle.

Reforms mainly tried to achieve a stable, efficient and functional economic governance able to deal with crises, prevention of deficits, debts and imbalances and fiscal sustainability. It is obvious though that the extent in which the reforms that took place in Europe the last years actually achieved this goal is minor and their effectiveness can be questioned.

What actually happened was the reinforcement of Intergovernmentalism. The EU institutions made some attempts to strengthen the Community method and to introduce fiscal coordination but obstacles appeared from member states (mainly Germany) which supported the increase of the power of the Council and the monitoring role of the Commission. They showed an augmenting reluctance to give power of economic governance and part of their sovereignty to central institutions. The Council, being formed by representatives of member states was facing difficulty in overlooking and ignoring their differences.

Crisis period is undoubtedly characterized by indecisive and insufficient political leadership. The recent reforms do not indicate the exact source of political decisions but an unsatisfactory decision making process and allocation of competences³⁶. European leaders were usually acting ad hoc and in fact they were dealing with the previous stage of the crisis. Their reaction has been “too little, too late”³⁷.

³⁶ Pisani-Ferry J., Sapir A., Wolff G. (2012) “The messy rebuilding of Europe” BRUEGEL 30 March

³⁷ Jacques Delors (2011) “Jacques Delors interview: Euro would still be strong if it had been built to my plan” The Telegraph, 2 December <http://www.telegraph.co.uk/finance/financialcrisis/8932640/Jacques-Delors-interview-Euro-would-still-be-strong-if-it-had-been-built-to-my-plan.html>

What is also observed is the fact that the influence of the two big member states in economic governance, is informally increased and became determinative and critical for every decision made³⁸.

In addition, since there is no more political consensus in European policies and the decision making has a more technocratic character, democratic legitimacy becomes an issue. It should not be forgotten that democratic legitimacy is a necessary aspect for the success the governance reforms.

Efforts to impose tough rules in order to achieve coordination did not succeed and when this was relied on member states' will, without enforcement, the result was the same. Even countries with political and policy making power denied implementation of the rule when they were facing difficulties (Germany, 2003). The sanctions did not make compliance more probable.

To sum up, Economic Governance in EU is characterized by considerable complexity and confusing policy making process. There are treaties outside the EU law, pacts following Lisbon Treaty and non euro-area countries participating but being excluded from certain policies. It is relying on a penalty regime and it is focusing on individual member states' economy rebuilding. However, there is no final form of European economic governance yet and there are many things to be changed in the near future.

Europe's inability to make authoritative and executive decisions is one of the main problems that should be solved in order for the union to be more effective. It is important to learn how to deal with the current crisis but also to eliminate the possibility of the eruption of a new one in the future.

The uncertainty that still characterizes the European economy, put many European citizens of different member states in hard living conditions. It prolonged the recession and deteriorated its consequences. In October 2011, after 4 years of reforms in euro and national level, 18.703 million people were unemployed in euro area, 2.174 million more than one year earlier. In Greece unemployment raised in one year³⁹ from 18.4% to 25.4%, in Spain from 22.7% to 26.2% and Portugal from 13.7% to 16.3% to name but a few⁴⁰. More data show that many other indicators have disappointing trend over time implying a decline of economic activity.

Another example is the very important indicator of GDP which shows that it decreased by 0.9% in the euro area during the second quarter of 2012 compared to 2011.

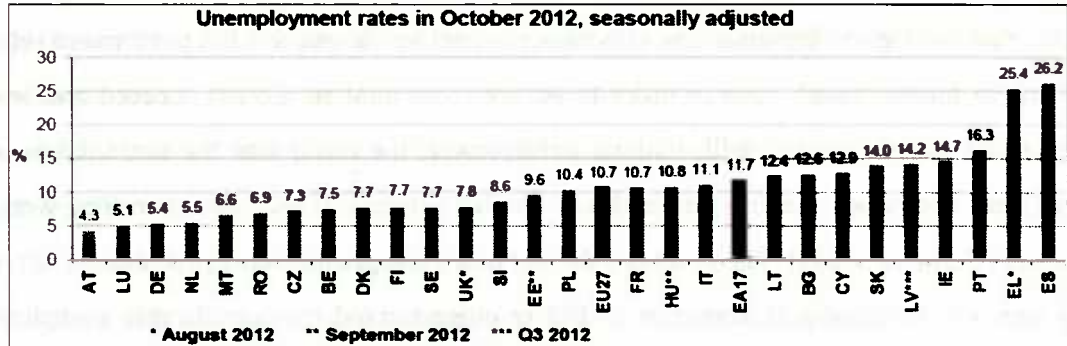
³⁸ Veron N. (2011) "Testimony on the European debt an financial crisis" BRUEGEL, September

³⁹ Between August 2011 and August 2012

⁴⁰ 3.609 million young people (under 25) were unemployed in euro area with higher rates in Greece (57.0% in August 2012) and Spain (55.9%). Data source: Euro-indicators release 170/2012 - 30 November 2012, Eurostat http://europa.eu/rapid/press-release_STAT-13-4_en.htm

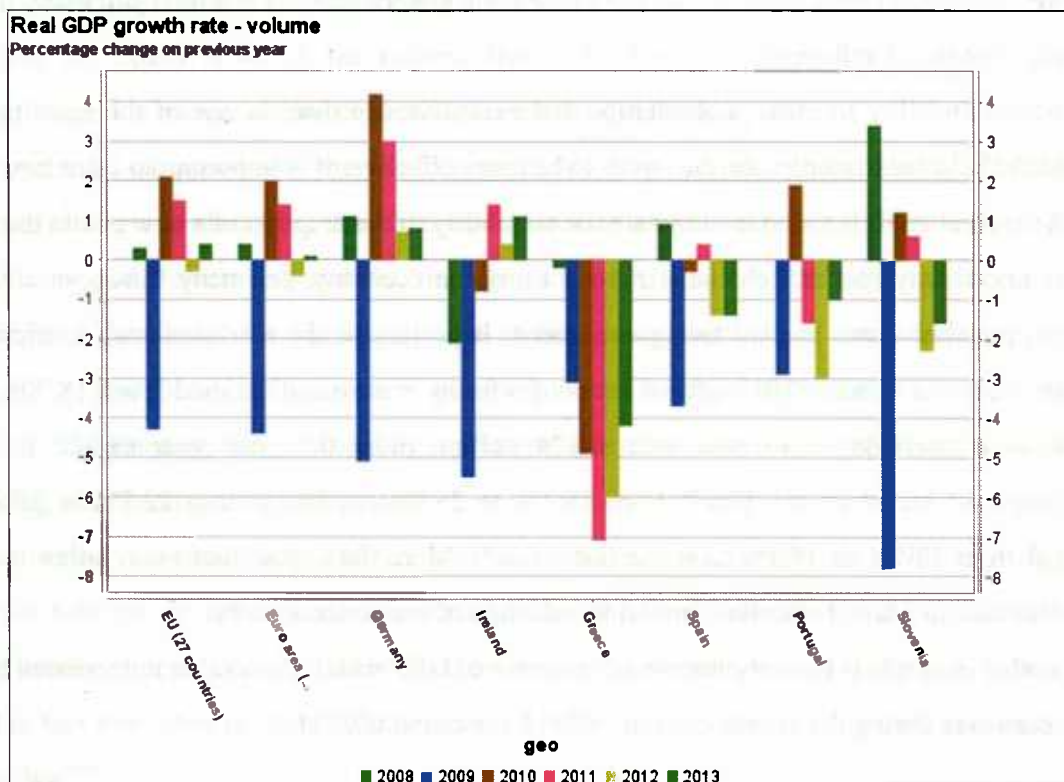
Furthermore, the forecasts and predictions for the near future are not optimistic as they indicate a further decrease on GDP and a continuous pessimism of firms and households contributing to the general negative prospects⁴¹.

Figure 4: Unemployment rates in October 2012



Source: Eurostat

Figure 5: Real GDP growth rate



Source: Source of Data: Eurostat, Date of extraction: 18 Jan 2013

⁴¹ Data source: "Eurostatistics Data for short-term economic analysis" Issue number 11/2012, Eurostat statistical books

2 Macroeconomic Imbalances and Competitiveness

Large macroeconomic imbalances (current account deficits, prices, wages and productivity) and losses in competitiveness have increased during the last decade and since the creation of EMU in some member states. One of the reasons that can be blamed about beginning the crisis in Eurozone can be the different debt accumulation in member states. The divergence on the amount of debt between the countries is because of the general macroeconomic divergences and imbalances. The imbalances appeared and grew over the last ten years in euro area damaging its cohesion. During this period the common monetary policy has been expansionary and there was a credit boom in the international financial markets. The domestic demand for consumption or investments, the level of savings (depends on cultural factors and fiscal discipline) and economic distortions are other factors that form the current accounts⁴². The current account imbalances occur as a result of differences in these factors across member states. The monetary policy, for example, is differently implemented in each country because of differences in financial structure (credit conditions-mortgages)⁴³.

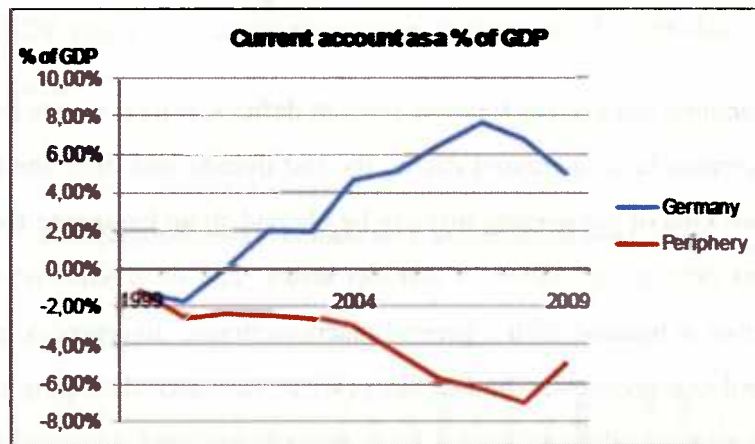
In the euro area imbalances were built up as a movement of capital flows from the north to the south⁴⁴ of the union in order to finance excessive consumption (Greece) and constructions (Spain) and this movement became possible by bank credit. The southern countries due to an increasing domestic demand which was financed by the south deteriorated their accounts and competitiveness. These countries experienced booms in economic activities, wage and price increases. Thus, the main imbalances in Eurozone have the form of current account surpluses in the north and deficits in the south. Figure 4 shows the current account as a proportion of GDP in Germany and in the group of the counties with the highest debts (Portugal, Ireland, Italy, Greece and Spain). The current account imbalances are not temporary but there is a certain divergence. According to the Commission, the convergence after 2007 could be cyclical caused by decrease in demand and imports.

⁴² European Parliament, Directorate General for internal Policies (2010) "Monitoring Macroeconomic Imbalances in Europe: Proposal for a Refined Analytical Framework" 8 September

⁴³ In Germany the access to mortgages was around 60% in Spain and Ireland it reached 100%
Gros D. (2012) "How to deal with macroeconomic imbalances?" CEPS No. 69/November

⁴⁴ According to their current account balance: North countries: Austria, Germany, Belgium, Luxembourg, Netherlands, Finland. South countries: Greece, Italy, Spain, Portugal, Ireland
Gros D. (2012) "How to deal with macroeconomic imbalances?" CEPS No. 69/November

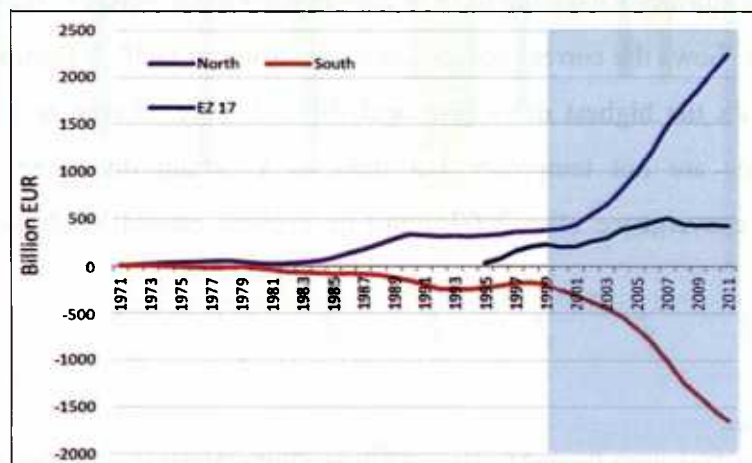
Figure 5: Current account balance



Source: Bruegel calculations, OECD Database

After a change in risk perception and in growth rates, these flows stopped as well as any market financing that the south countries used to have. So they had to deal with large stock debt and no financial resources. Eurozone's goal was to face and correct the imbalances with adjustment mechanism and to prevent appearance of new, as they cause negative effects like unemployment and decreasing GDP. The current account imbalances decreased the last years due to the tight economic situation in the south and limited demand. But this does not change the large 'stock imbalances'⁴⁵ accumulated in many years.

Figure 6: Stock current account imbalances



Source: European Commission Services (Ameco) data⁴⁶

⁴⁵ Gros D. (2012) "How to deal with macroeconomic imbalances?" CEPS No. 69/November

⁴⁶ Gros D. (2012) "How to deal with macroeconomic imbalances?" CEPS No. 69/November

It should be noticed that the current account of the euro area as a whole is generally balanced (not completely though and it never was as it has a stable deficit around 2.3 %⁴⁷), meaning that there is always the ability to cover all needs⁴⁸. Thus, it's a matter of savings distribution, taking into account the unwillingness of the north to activate financial flows to the south⁴⁹. At the European level, the European Commission suggested that the macroeconomic imbalances should be dealt with a framework including a preventive arm with clearly defined indicators for warnings (like current account balances, real effective exchange rates, government debt and the ratio of private sector credit to GDP), and a corrective arm according which member states are forced to have specific reactions but there is also an enforcement mechanism. The proposal of the Commission actually includes sanctions and stricter surveillance for the countries that do not succeed in structural reforming. However it is not certain that the suggestion is appropriate to address the divergences.

Figure 7: Current-account balance as a percentage of GDP, 1993-2014

	8-year averages							Autumn 2012 forecast		
	1993-97	1998-02	2003-07	2008	2009	2010	2011	2012	2013	2014
Belgium	4.7	4.8	4.1	1.1	0.7	3.0	1.0	0.7	0.9	1.2
Germany	-0.9	-0.4	5.1	6.2	6.0	6.1	5.6	5.7	5.0	4.7
Estonia	-6.6	-7.1	-12.9	-8.5	4.2	3.2	0.3	-0.9	0.1	0.4
Ireland	3.0	-0.1	-2.3	-5.7	-2.3	1.1	1.1	2.3	3.4	4.4
Greece	-0.9	-8.9	-13.0	-18.0		-12.8	-11.7	-8.3	-6.3	-5.2
Spain	-0.6	-3.2	-7.3	-9.6	-4.8	-4.4	-3.7	-2.4	-0.5	0.4
France	1.1	1.7	-0.4	-1.9	-1.8	-2.0	-2.6	-2.2	-1.8	-1.9
Italy	2.0	0.5	-1.0	-2.9	-2.0	-3.5	-3.3	-1.2	-0.4	-0.3
Cyprus		-1.2	-6.6	-12.2	-10.7	-9.2	-4.2	-4.3		-3.0
Luxembourg	11.9	10.0	10.4	5.4	7.2	8.2	7.1	4.4	4.9	4.7
Malta		-4.6	-6.4	-5.0	-7.4	-5.0	-0.3	2.1	1.8	1.6
Netherlands	5.3	4.9	7.9	4.7	3.2	5.1	8.3	9.2	9.8	9.8
Austria	-2.5	-0.3	2.7	4.8	2.7	3.5	1.1	1.1	1.2	1.6
Portugal	-5.4	-9.3	-9.2	-12.6	-10.8	-9.7	-6.6	-3.0	-1.8	-1.5
Slovenia	1.0	-1.5	-2.4	-6.1	-0.4	-0.4	0.1	2.0	2.7	2.3
Slovakia	-3.0	-6.2	-7.1	-6.3	-2.5	-2.5	-2.5	1.4	1.4	2.2
Finland	2.4	7.3	4.7	3.1	2.0	1.6	-1.1	-1.6	-1.6	0
Euro area	0.7	0.3	0.6	-0.7	0.1	0.3	0.3	1.1	1.5	1.6

Source: European Commission (European Economic Forecast 2012)

The European Systemic Risk Board (ESRB) and the Excessive Imbalance Procedure (EIP) can contribute in avoiding new imbalances but for already existing they can merely help by reinforcing the procedures of adjustments like limiting the financial systemic risks that can appear, finding the areas of distress and guiding the member states towards rebalance. The systemic risks are connected with the macroeconomic imbalances and sometimes need the same policies to overcome them.

⁴⁷ Collignon S. (2004), "The End of the Stability and Growth Pact?" International Economics and Economic Policy CEP Volume 1, No1, January

⁴⁸ Gross D. (2012), "Macroeconomic Imbalances in the Euro Area: Symptom or cause of the crisis?" CEPS, No. 266, April

⁴⁹ De Grauwe P. (2012) "In search of symmetry in the eurozone" CEPS, No. 268, May

In Eurozone the boom in housing market actually increased the connection in banking system by interbank lending and cross-border lending and as a result systemic risks increased and led to excessive instability of financial sector⁵⁰.

To address the imbalances measures and rules is necessary to be introduced in Eurozone. However common policies could not be sufficient and effective if we consider the divergences between member states, so country specific policies and structural reforms should be implemented. This includes the use of different instruments. In the case of a credit and demand boom there would be recommendations about taxes, banking, availability of credit and also fiscal advices.

Taking into account the fact that the crisis has national origin and that the divergences appeared because of national actions (demand, credit, consumption, savings), it's reasonable that the convergence of member states is mainly pursued by focusing on the actions of governments. That means that they focus on how to change macroeconomic variables and how to make structural reforms using instruments like budget policies which are not flexible. Yet it is the combination between credit and national activity that forms the flows of capital and at the end the divergences.

Therefore the control of credit in the countries is very important factor for limiting the divergences, a factor lying in the hands of the EU monetary authorities and mainly the ECB and not in the government. Contrary to popular belief, the ECB should not only be responsible for the Eurozone as a whole and it does not have one and only objective, the maintenance of price stability. ECB is the monetary authority that should bring and keep the financial stability in the Eurozone and it is the only institution that actually has the tools to achieve it. The ECB should take into account the situations in individual countries and react when excessive bank credit is seen in some member states in order to avoid the consequences⁵¹. Yet what the ECB did was to ignore also the system-wide signals before crisis which showed an increasing Eurozone bank credit⁵². The tools that the ECB and the Eurosystem can use to control credit expansion can be the minimum reserves requirements, capital ratios to act as an anti-cyclical instrument, growth rate of bank credit.

The fact that the European Systemic Risk Board has as president the president of ECB and voting members from national central banks shows that the systemic risks is a concern not only of the new institutions (ESRB, EIP) but also of the ECB and the Eurosystem.

⁵⁰ Wolff G. (2011) "The euro area's macroeconomic balancing act" BRUEGEL, May

⁵¹ De Grauwe P. (2010) "What kind of governance for the Eurozone?" CEPS No. 214/September

⁵² Bastian J., Begg I., Fritz-Vannahme J. (2011) "Making the European Union work" Issues for Economic Governance Reform, Bertelsmann Stiftung, 3 March

Concerning competitiveness, in general labor cost and productivity can affect it. However, it is not sure that higher productivity will lead to higher competitiveness because maybe the wage increase will overpower the improvement of productivity. And what affects wages? Large increases in wages are in general connected with the increase in domestic demand over the last decade. In principle a loss of competitiveness should lead to lower exports, or at least lower market shares but this is not what happened. Uncompetitive economies had high level of exports, so their deficits came from the import side with excessive domestic spending.

In Europe structural reforms in labor market are asked in order to face the competitiveness deficits in some countries. But these reforms cannot address the problem of divergence in competitiveness because as it has been argued, they are not much related with the changes in competitiveness. On the contrary competitive divergences are more related to macroeconomic conditions. Most of the loss of competitiveness in peripheral Europe arose once unemployment had been much reduced. So the reason of lower competitiveness was “not the lack of structural reforms or unreasonable trade unions, but rather to booms in domestic demand, fueled mainly by the easy availability of cheap credit”⁵³. Consequently, the way to deal with it is to control domestic demand and capital inflows to stabilize labor market and not focus on changes of wages, productivity and other aspects of labor market. Reforms on economic governance in Eurozone should focus on actions and responsibilities of governments as much as on those of Eurozone monetary authorities⁵⁴.

⁵³ Gros D. Alcidi C. “Fiscal Policy Coordination and Competitiveness Surveillance: What solutions to what problems?” CEPS No. 213/September

⁵⁴ De Grauwe P. (2010), “The Financial Crisis and the Future of the Eurozone”, BEEP briefing n° 21, College of Europe, Department of European Economic Studies

3 Fiscal Union

Earlier in this paper we showed the reaction of policy-makers to the crisis concerning economic policy and governance. Yet, it was inefficient in various ways. On the ground of imbalances, competitiveness and growth structural reforms, even if the direction of action was right, there is a question of legitimacy and of insufficiency in the extent of the movement of sovereignty to the euro-area level.

On the ground of financial assistance, new mechanisms that provide help to countries with problems are created. The new framework contains a wide range of instruments that differ on aspects like governance, target group, size of assistance that they can provide, method of voting etc. (see EFSM, EFSF, ESM). On top of these, an important difference is regarding the source of decision about financing. Concerning this aspect, we have decision by the Eurogroup, the ECOFIN and the Council. The product of these reforms is a complicated system. In addition, the permanent mechanism for dealing with crisis, ESM, has some disadvantages like the long time needed for a decision and its limited size, not enough to cover more countries if needed⁵⁵.

It is clear that the current form and structure of EMU is unsatisfactory for the member states. EMU lacks of fiscal cohesion and countries do not have fiscal connection with each other. At this point, the current problematic situation partly forbids a discussion about a complete political union in EMU, or leaves it for the future⁵⁶. Currently what we can think about is a limited fiscal union, which is actually necessary for the survival of Eurozone. Some functions and activities should be centered in the euro area level where fiscal resources should be available and more steps can be made towards a tighter union.

The efficiency of euro area could be improved if crisis prevention and resolution method would be simplified. For crisis resolution there are some proposals that suggest ways to move towards a fiscal union since the political unification seems to be hard to achieve⁵⁷.

⁵⁵ Marzinotto B., Sapir A., Wolff G. (2011) "What kind of fiscal union?" BRUEGEL, November

⁵⁶ De Grauwe P. (2011) "Managing a fragile Eurozone" CESIFO 2011

⁵⁷ De Grauwe P. (2010) "How to embed the Eurozone in a political union", VOX, 17 June



3.1 Common Issuance of Debt

The creation of all these mechanisms and arrangements the last years by the policy makers, resulted also from the lack of a formal pooling of resources for inter-governmental fiscal support that could be used for any financial problem in the euro area. With a fiscal union the euro area could benefit from a mechanism that would issue debt at the European level without the credit risk that is met at the national level. The mechanism would ideally stabilize the financial markets and lower credit risk premiums. It would lower the cost of borrowing and give some risk-sharing characteristics to the union by lowering spreads. Furthermore, the common issuance by undermining the links between banks and government debt it would decrease the possibility of feedback loops between sovereign and banking illiquidity which also affects the real economy. Besides this, it would also reduce the chance of cross-border capital flows as the assets would not differ much in safety⁵⁸. It would be necessary to create a surveillance-monitoring system to guide and control the national budget policies whose discipline can be crucial for the sustainability of the monetary union. Bonds in euro area are issued separately from the governments of 17 member states. Thus, the market can occasionally suffer from high risk, depending on the financial situation of the countries. This is a barrier to financial and fiscal integration.

If the common debt issuance will be based on basic economic and political principals it could achieve an appropriate and well functioning transmission system of monetary policy from the ECB without the barriers of national shocks. It would also show to investors that there is a stable, low-risk bond market in Europe capable to attract investments.

The creation of a system for common issuance of debt in euro area level has been pursued by different ideas for such an instrument. Of course, any proposal about pooling debt together and common debt issuance contains the possibility of free riding. Hence, fiscal discipline to specified structure should be taken into serious consideration. It should not be forgotten that previous attempts to impose fiscal rules failed because of lack of enforcement mechanisms. It became clear that the fiscal stability and consolidation cannot be relied at the discretion of the governments of the member states or on potential punishment for rules violation. Examples of the recent history show that this is not effective and always lacked of credibility (Maastricht criteria, SGP).

⁵⁸ Claessens S., Mody A., Vallee S. (2012) "Paths to Eurobonds", BRUEGEL, July

3.1.1 The Eurobonds

It is possible that the Eurobonds would not help the member states with unsustainable debt like Greece to solve their problem and reverse their increasing debt/GDP ratio but they could contribute to the improving of fiscal framework and credibility in order to reduce the chances of a future debt crisis eruption. There is however the fear, expressed by Germany that countries free-riders would appear and relieved by the fact that debt is common, they would issue more than what they can repay, creating an even worse situation. The governments of countries with high spreads and large debts like Greece, Portugal and Ireland will not have enough reasons and incentives to try more for sustainable fiscal policies. Consequently, countries without borrowing problems like Germany may have to bail out more than one member states, if they reach the state of default⁵⁹.

There are many proposals concerning the Eurobonds. They started as a way to address the crisis and continued as a potential fiscal reform of EMU. One of them is from Paul De Grauwe and Wim Moesen (2009)⁶⁰. This proposal suggests that the bonds issued by European Investment Bank (EIB), or directly by the member states' governments would have different interest rates and proceeds for every country depending on its current market situation. This would decrease the free riding problem, leave Germany with the same interest rate and help countries like Greece to have access to funds. The divergence of borrowing costs would decrease but it was argued that it would not help with debt sustainability and it could deteriorate the situation.

What Germany proposed concerning this matter is the European Redemption Fund and the 'debt brakes' that is part of the Fiscal Compact.

3.1.2 'Debt Brakes'

According to the German proposal the euro area member states would transfer the part of their debt which is over 60% of GDP into a European Debt Redemption Fund. All the countries participating would be legally responsible for this fund which would contain around 27% of Eurozone GDP and they would have to pay off the bonds in the next 25 years. This proposal would start to be implemented with the approval of the Fiscal Compact which is actually a stricter version

⁵⁹ Claessens S., Mody A., Vallee S. (2012) "Paths to Eurobonds", BRUEGEL, July

⁶⁰ De Grauwe P., Moesen W. (2009) "Gains for All: A proposal for a common Eurobond" CEPS

of the Stability and Growth Pact, a pact that failed to reach its goals. The ‘debt brakes’ do not put a barrier on moral hazard but only suggests sanctions and punishment in a way that was suggested before. The problem is that the excessive deficits are not diminishing because it is not credible that punishment will be imposed. In cases of non-compliance with the criteria, country officials could set the country free from any obligation or accountability. The lack of enforcement mechanism cannot be overlooked or substituted by incorporation in the national constitutions and laws or by more strictness of the rules⁶¹.

In Eurozone there have been some facts that reinforced the temptation to not follow the rules and the moral hazard. The last years, there has been the idea that the bail-out will at the end take place and no sovereign bankruptcy is foreseen and since the creation of euro, countries with high debt could borrow money with very low interest rates (Greece could borrow money with the same interest rate as Germany). The fiscal challenge is to manage to have an effective financing system with low interest rates for cheap funding of governments, lower burden for taxpayers and high interest rates for borrowers proceeding to unsustainable debt accumulation.

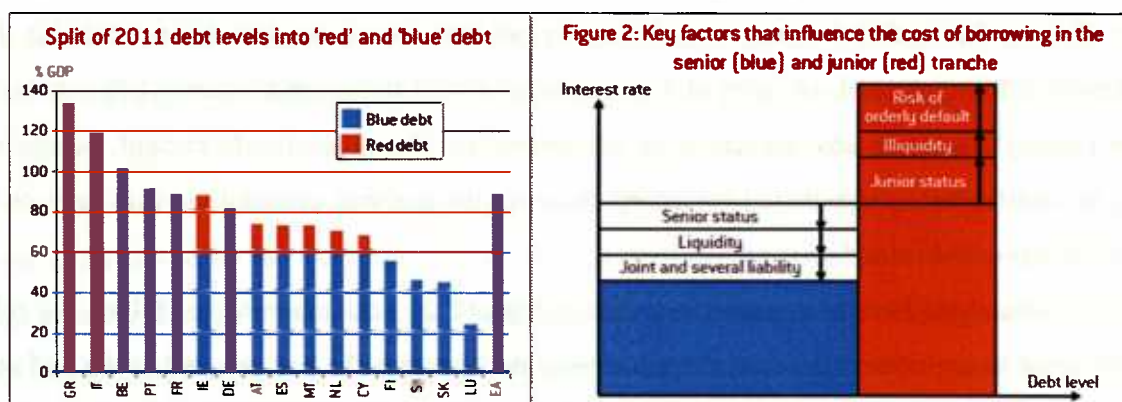
3.1.3 The blue bond proposal

This proposal⁶² suggests that countries should transfer up to 60% of GDP of their debt in a common issuance of European government bond (Blue Bond). Above this, any other debt that the governments would issue, it would be in national level (Red Bond). Currently the borrowing cost of every government is the debt times the interest rate. It is suggested in this proposal that this cost should be divided in two: first, the blue bonds up to 60% of GDP which will be the first to be paid so they will have low risk and lower interest rates than the national bonds currently. Second, the red bonds with higher risk and higher interest rates. Therefore, in case of a partial country default, the part of red bonds will be defaulted first, increasing the risk premium further.

⁶¹ Frankel J. (2012), “Could Eurobonds be the answer to the Eurozone crisis?” VOX, 27 June

⁶² Delpla J., von Weizsäcker J. (2010) “The blue bond proposal” BRUEGEL, May

Figure 8: Debt levels & Cost of borrowing



Source: Depla J., von Weizsacker J., - *The blue bond proposal* (2010), Bruegel

There are three effects expected in this proposal that will help reduce the borrowing cost of countries in Eurozone. The first is that the liquidity in the blue bond market will be higher since it could include 60% of euro area GDP. In addition this market could be attractive to investors like central banks and sovereign wealth funds because of safety and certain liquidity and this would increase the liquidity even more. The increased liquidity would also improve the resilience flexibility and recovery in case of a borrowing crisis for large and smaller economies. On the other hand, the liquidity of the red bond market would be of a smaller amount than the current national liquidity, giving to red bonds higher borrowing costs. The second effect is the fact that the blue bonds would have joint and several liability ensuring that in any case money shortage in one country, the others must make up the difference. This would create a triple A asset and reduce the risk even more. Last but not least, the increased possibility of default on the red debt and the stricter supervision of the financial system to make sure that it would remain stable in that case, would lead to an improvement of the countries' fiscal discipline and this to a lower cost of borrowing.

The proposal suggests that the fiscally disciplined countries would be able to borrow up to 60% of GDP and those with not good fiscal situation a smaller amount. This way the blue bonds would give incentives to the member states with higher debts to try to decrease them and follow the fiscal rules as much as possible because they have to gain from this.

In case of unsustainable debt crisis (debt accumulations larger than 60% according to Maastricht criteria), there will not be any guarantee and the no-bailout clause is actually supported. This is a difference between the blue bond proposal and Eurobond proposals that suggest all the debt to be pooled together, an opinion rather extreme for the current situation.

Concerning the allocation of blue bonds, in this proposal it is suggested that a fiscally credible independent council should make the recommendation and the national parliaments would be responsible to decide to 'take it or leave it'. The transmission to this system would take place in each country by treating the current red debt as senior and the current blue debt as junior. Gradually the debt would be replaced by senior blue and junior red debt. Of course resolutions and settlements of other problems should be approached at the same time like the problematic bank sector that affects all the markets.

All countries (especially smaller) will profit from the increased liquidity of the market with lower borrowing costs. The countries with high level of debt will have incentives to try more to arrange and improve the fiscal situation in order to participate in the market. The discipline and compliance which are now missing would come from the market interest rates and not by officials or threats of punishment. The automatic way that the red bonds' risk premium would change would finally alert the non-compliant countries.

The effort towards fiscal adjustment would be embraced by all countries and countries like Germany that worry about being the one to pay the most, would be benefited from the total disciplined structure of the bond market even if it is reasonably hard to persuade the taxpayers that this time the money they pay will actually be profitable.

3.2 National Budgetary Guidance – Financial Ministry

Even if the political integration in EMU is an issue mainly for the future because it requires a more mature, complete and integrated monetary union, there were certain proposals suggesting that the creation of a financial ministry with responsibilities and certain influence over the national budgets could be foreseen. Furthermore fiscal resources should be available in order to manage and deal with financial difficulties of member states. The fiscal architecture of EMU should be restructured and reinforced. The potential ministry would manage the revenues of the euro area and cooperate with the ECB in case of potential losses from the more active role that it should have in EMU, which is described later.

An intervention of the finance ministry could also be the commitment to pay for countries in case of lack of resources, in order to avoid the rise of borrowing costs⁶³.

⁶³ Marzinotto B., Sapir A., Wolff G. (2011) "What kind of fiscal union?" BRUEGEL, November



Any steps have to be accompanied by regulation and supervision of the financial system since at the time being the national fiscal capacity cannot cover the banks' lack of liquidity. Thus, the finance ministry could organize a corporation to supervise the banks and also act as a deposit insurance for banks. As a result the ministry would help to cut the bond between banks and governments which tends to have great impacts in times of crises in transforming sovereign incapacities to liquidity and then to banking crises.

In a Fiscal Union, a control and guidance of budgetary decisions and policies is also necessary. This, demands for a partial movement of sovereignty from the national to the European level but not the policy making. The budget issue became rather controversial as many member states are not ready to move powers to the supranational level. Power on budgetary choices could also mean power on taxing citizens of member states in order to have a common budget. One policy option has been to create a federal budget the size of which is arguable. European citizens would be opposed to being taxed further for the European integration specially at the time being. The money from taxing would be necessary to a potential finance ministry in order to deal with problems of illiquidity and bad loans to member states or in cases of recapitalization of banks with excessive cash needs until a bank fund would be able to cover them⁶⁴.

Fiscal restructuring should be democratically legitimized. Crucial decisions that influence European citizens would be taken, like intervention to national policies, possibility of taxation and spend policies. Therefore the European Parliament and the other institutions and the governments should be directly involved.

There are different types of fiscal union from which the European policy and decision makers have to choose. They can make a choice between a major step towards fiscal integration or a way to deal with non-compliant member states, with rules and 'ceilings' in order to manage sovereign and liquidity crises. The SGP has been proved inadequate to take priority over the national sovereignty. It did not achieve fiscal convergence and discipline through the creation of incentives for the member states.

On the contrary EMU and the recent reforms decreased motivation for fiscal restructuring since the idea of bailout actually decreased the interest rates and spreads (but not in a way that could promise fiscal stability). The chance of fiscal and economic mismanagement in euro area is not avoided neither the possibility of shocks in member states that could affect the whole EMU.

⁶⁴ Veron N. (2012) "The challenges of Europe's fourfold union", BRUEGEL 13 August

3.3 Crisis prevention - sovereign debt resolution

Even if the most effective fiscal cohesion with the appropriate legislation and accountability will be achieved, there will always be a possibility of future debt crises in the euro area. A mechanism for dealing with sovereign-debt is needed to predict, manage and resolve them. Two proposals will be described. The first is a restructuring an default mechanism and the second is a European Fund.

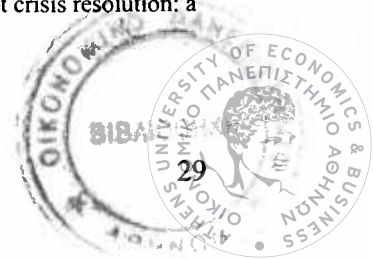
3.3.1 European mechanism for sovereign debt crisis resolution

This mechanism⁶⁵ would include negotiations between a sovereign debtor with unsustainable debt and the creditors, in order to reduce the debt and regain fiscal sustainability. It would provide incentives and it would have to balance the interests of both parts to avoid moral hazard. The assistance would come from a permanent European fund that could be ESM. Sovereign-debt resolution foresees fiscal adjustments by the government and cut of the debt. This would make the remaining debt sustainable and improve the fiscal situation of the country. The objective is the fair distribution of the cost of restructuring. The unsustainable debt usually takes the country out of the market depriving it of its ability to borrow. The mechanism would support the country in this period and this way it would achieve management of debt restructuring crisis.

However, it is argued that this mechanism will make the Eurozone more fragile since it implies that investment in sovereign bonds is not guaranteed⁶⁶. The mechanism is based on a wrong cause of crisis. The cause was not the sovereign debt but the private (except in the case of Greece). The first increased by taking over part of the second and through the automatic stabilizers. If a sovereign debt default mechanism exists, it is like admitting to the investors that it is possible that governments will apply a haircut of the debt. This will increase risk and interest rates making the repayment of the debt even more difficult. The mechanism could be a disincentive for discipline of countries and therefore reason for instability. This mechanism is considered to be a substitute of financial help from other member states and this makes it attractive as financial assistance is 'politically unacceptable'.

⁶⁵ Von Hagen J., Sapir A., Gianviti F., Krueger A. (2010) "A European mechanism for sovereign debt crisis resolution: a proposal" BRUEGEL

⁶⁶ De Grauwe P. (2010) "A mechanism of self-destruction of the Eurozone" CEPS, 9 November



However, it is argued that assistance in the union is a pillar that keeps it stable. And this leads us to the second proposal, the European Monetary Fund with strong conditionality.

3.3.2 European Monetary Fund (EMF)⁶⁷

When joining the Eurozone, the member states tie their economies by having the same currency. It cannot be expected that when one country has problems, the others will not be affected. The principle of solidarity gives them also the responsibility of trying to avoid creating problems for the other member states but also receive help when needed. The proposal of EMF suggests the establishment of a permanent fund to support countries when they face financial problems. It would include a mechanism to limit the moral hazard. This could happen by collecting contributions depending on the risk that each member state has which depends on country's deficit and debt levels⁶⁸. The EMF could then give a guarantee for an issuance of public debt. The proposal suggest strict conditionality that says that a member state could use the amount of fund that it has deposited on EMF and if it needs more it has to follow an adjustment program with supervision of the Commission and the Eurogroup.

Concerning the enforcement, the EMF foresees potential interruption of funding from EMF (in form of guarantee) but also from structural funds and exclusion from the Eurozone's money market. The EMF is expected to give incentives for fiscal order and with an orderly sovereign default procedure it will manage the distorting results of a default and gain credibility.

⁶⁷ Gross D., Mayer T.(2010) "How to deal with sovereign default in Europe:Create the European Monetary Fund now!" CEPS

⁶⁸ Contribution of 1% annually of the excessive debt(above 60%of GDP and 1% of the excessive deficit(above 3%of GDP). In the case of Greece with data of 2010: debt 115% of GDP contribution 0.55% to EMF



4. Banking Union

The EMU doesn't have a coherent and complete financial and banking policy to support its monetary policy. Besides the common regulations and deposit standards, banking policy was not harmonized and many weaknesses were revealed by the crisis concerning banking system in EMU. Capital was not moving from the north to the south causing imbalances in the current accounts. Interbank market was shrinking since the banks started to limit their transaction behind the national borders refusing to lend to other countries. Furthermore, since the bank portfolios included big amounts of government bonds and governments were in charge of bailing out banks, sovereign and bank crisis were linked and connected, putting the countries and taxpayers in great risk. It's impressive to see the EU sovereign debt in the banks' portfolios: Greece (94%), Spain (90%), Portugal (79%), Italy (78%)⁶⁹. The policy makers at the beginning of the crisis ignored systemic risks and did not evaluate the extent and losses of the crisis. What they focuses on, was providing liquidity into the financial system and mainly in national level without European coordination.

On the subject of crisis management, it is worth mentioning that there was no institution capable of finding malfunctioning financial institutions, identify the problems and resolve them. Even if at the recent reforms and legislations did not include a framework for centralized banking functions, recently a favorable climate for a banking union is being created.

To begin with, in short-term period it is necessary to move closer to a systemic bank crisis resolution⁷⁰ coming from a qualified resolution authority in order to regain trust in the banking system. In euro area level the capital assessment and recapitalization of banks was not a priority and it was left to national authorities who did not succeed in supervising and they are not considered as a credible authority for bank resolution anymore. In addition, the interlinkages and cross-border relations of banks in Europe are huge and affect the stability of the union. This is the reason why the centralized restructuring of systemically important banks that takes into consideration the interests of all member states is important for the resolution.

This was the US response to the bank crisis of 2008, with the Supervisory Capital Assessment Program which included stress tests by the Federal Reserve System and Office of Thrift Supervision to determine if the largest banks in US, which actually were the heart of the US banking system,

⁶⁹ Veron N. (2011), "Banking federalism key to Eurozone survival" Emerging markets, 3 November

⁷⁰ Veron N. (2012) "The challenges of Europe's fourfold union", BRUEGEL 13 August



had sufficient capital to survive during the crisis. They also wanted to have an image of potential losses, resources and capital needed⁷¹.

What was also very important was the Chairman's statement highlighting the fact that the government would be 'ready to provide whatever additional capital may be necessary to ensure that our banking system is able to navigate a challenging economic downturn'⁷². The trust and confidence financial institutions are very important elements for averting threats of stability in the banking system.

A capital assessment program in euro area could identify the problems, change the expectation of high loss rates and work against uncertainty by estimating and evaluating the potential current and future losses. Additionally and in cooperation with national authorities it would decide how to deal with unsustainable banks and deposit flights across euro area, which are mainly led by fear of losses on the deposits, lack of guarantees and the uncertainty mentioned earlier. It could be implemented by a temporary authority, impartial and specialized with accountability for decisions and actions⁷³.

Ideally all member states of European Union should participate in the banking union, steps for which are recently made. However, this creates complexities, difficulties and confusion (due to different currencies, central banks) and some member states already showed that they have no intention of joining the banking union⁷⁴. The members of the euro currency union are automatically considered part of the banking union. The banking union should be on the scope of systemically important banks and organizations but also national smaller banks, even if they do not have cross-border operations. If there was a partial banking union, its decisions would affect more the countries with systemically important banks and others not, creating asymmetry, competitiveness distortions and maybe undermining local banks⁷⁵.

⁷¹ Board of Governors of the Federal Reserve System (2009) "The Supervisory Capital Assessment Program" May 7 <http://www.federalreserve.gov/newsevents/speech/bcreg20090507a1.pdf>

⁷² Bernanke Ben S. Statement, 7 May 2009 <http://www.federalreserve.gov/newsevents/press/bcreg/bernakescap20090507.htm>

⁷³ Pisani-Ferry J., Sapir A., Veron N., (2012) "What kind of European banking union?" BRUEGEL June

⁷⁴ UK Prime Ministers David Cameron "*...the Eurozone, needs a banking union but Britain won't be part of this banking union and we have properly protected our interests in the single market...The broader discussion will be how Europe is changing and a lot of that change is driven because of the euro, because the countries in the euro need to integrate more.. Britain's not in the euro, we're not going to join the euro so we won't be part of that integration*", Independent (2012) "Cameron presses for new EU deal", 13 December <http://www.independent.ie/breaking-news/world-news/cameron-presses-for-new-eu-deal-3325032.html>

⁷⁵ Pisani-Ferry J., Sapir A., Veron N., (2012) "What kind of European banking union?" BRUEGEL June

A complete banking framework consists of regulations, supervision system, resolution mechanism and provisions of guarantees and deposit insurance. Their primary objective is to regain and maintain financial stability and protect taxpayers from risks and losses and it should aim at the initiation of a framework, composed of competitive banks and diminishing deposit flight.

4.1 Regulations

The banking regulations' objective is to organize a stable resilient system and capable to avoid negative effects on society in case of shocks. In euro area regulations are actually a rather consistent pillar of banking policy that has perspective of being further integrated. Since 1999 with the Commission's Action Plan for single financial markets legislation, regulations and directives started to be outlined. Their purpose was the improvement of single market for financial services by eliminating barriers and obstacles and establishing common rules. Since then, the banking sector had a series of directives⁷⁶ towards the 'single rulebook' for banking with the last being in September 2012 which is an important step for banking integration.

In September 2012 the Commission made a proposal concerning the banking coherence in EMU. According to this proposal the ECB in cooperation with the European Supervisory Authorities will undertake important supervisory tasks of credit institutions and the rest of tasks will remain the competence of national supervisors. The tasks of the ECB will be:

- to detect risks for banks' sustainability and demand the necessary action
- to authorize banks
- to ensure compliance with minimum capital requirements and leverage taking into account the risk profile of a credit institution
- to apply capital buffers and intervene when requirements are breached.

It includes however only provisions about regulation and supervision. A resolution and a deposit insurance mechanism are postponed and left in national authorities.

⁷⁶ The three legislative packages included: 1. the 'Banking Directive 2000/12/EC which aimed to improve the clarity and transparency of the EU legislation and to create a kind of "European Banking Act"'.
2 'Directives 2009/111/EC, 2009/27/EC and 2009/83/EC, of the second legislative package aimed at ensuring the financial soundness of banks and investment firms'.

3. 'Directive 2010/76/EU on capital requirements for the trading book and for re-securitisations and the supervisory review of remuneration policies'. Europa/Commission -single market policies
http://ec.europa.eu/internal_market/bank/regcapital/legislation_in_force_en.htm

This could cause disagreements in the Union in case that the ECB decides to close one bank and not save it or if it makes a risky decision that turns out to be mistaken. Then National authorities (deposit insurance) would complain for paying for this mistake. Different authorities for supervising and deposits give wrong incentives. Proper incentives would be given to European supervisors if also deposit insurance and resolution were moved to the Eurozone level⁷⁷.

4.2 Supervision

Supervision of banking system is the way to monitor the actions and keep under observation and control the risks that this activity can cause to the system, the country and the taxpayers. In Europe the supervision of banks is mostly made in the national level, from national supervisors, following the subsidiarity⁷⁸ principle. However, steps have been made to organize and coordinate the individual national supervision of banks the last years⁷⁹ as a response of EMU to the banking and sovereign crisis.

There is consequently a contradiction between two objectives in the sphere of supervision, the subsidiarity and the decrease of links between banks and sovereigns. The first gives authority to national officials and the second suggests movement of power to European supervisors.

Supervising in European level is very important for the banking system. Common rules and enforcement across the member states, free from pressure of national lobbies and support of national supervisors to the problematic local banks. Who should be responsible for supervising? A complete and adequate supervision of the banking system can be considered that includes cooperation and interaction of a Supervisory Authority, the European Resolution Authority, the national supervisors and the institution that has the function of 'lender of last resort' ideally the ECB. The precedents' combined effort could lead in a better result than separated uncoordinated actions. The role of the ECB in supervising is crucial in many aspects. In contrast to the national supervisors, the ECB would intervene and protect cross-border lending and interbank lending.

⁷⁷ Wyplosz C. (2012), "Banking union as a crisis-management tool" VOX, 16 October

⁷⁸ According to this principle of European Union, the EU may only act where action of individual countries at national level is insufficient or ineffective (unless it's an area of exclusive EU competence)

⁷⁹ Example is the European Banking Authority (EBA) part of the ESFS, which task to establish standards, practices and opinions and to develop guidelines and recommendations for the Union institutions.

They decreased a lot since 2010 highlighting the desire of northern Europe to protect the home finances and resulting in increasing savings there and worsening the Eurozone situation⁸⁰.

4.3 Bank Resolution Mechanism/Authority

This authority's main objective should be to act as a prevention mechanism for systemic disorder and taxpayers' losses in case of a banking shock. Important elements to focus would be the deposits, the value of assets, potential restructuring and protection of the European banks and taxpayers from national mismanagement. Banking crisis resolution had been left to national jurisdiction and national regimes were to be coordinated by the EBA. The function of resolution could be exercised by a new independent and credible institution.

4.4 Deposit guarantee/insurance

The deposit insurance would create a certainty that the values of deposits are safe and will be covered in case of a shock. It is a very important aspect of the banking stability as proven with the current crisis. However, it is not yet organized and harmonized in the European level as it should, but governments back the deposits. National guaranties though, (i.e. fiscal resources) are not enough to cover national deposit and usually banking and sovereign financial situation is connected (feedback loop). Supported by the fiscal union and fiscal resources at the European level, the deposit insurance could be entirely centralized and back the banking system.

Or it could be relied on national deposit insurance schemes (DIS) up to a level and supra-nationally insured by a European fund, always supported by the fiscal union⁸¹.

As time was passing, the crisis has revealed the need for the European Central Bank (the ECB) to support the banks as well as the governments and to be more active as the primary financial institution of the European Union. *"A necessary condition to stabilize the banking system consists of providing for a lender of last resort."*⁸²

⁸⁰ Carmassi J., Di Noia C., Micossi S. (2012) "Banking Union: A federal model for the European Union with prompt corrective action" CEPS, No. 282, 18 September

⁸¹ Gross D., Schoenmaker D., (2012) "A European Deposit Insurance and Resolution Fund - An Update" CEPS, No. 283, 11 September

⁸² De Grauwe P. (2011), "Only a more active ECB can solve the euro crisis" CEPS August

4.5 Lender of last resort

In a monetary union like EMU the governments issue debt in a currency that they do not control, which means that they cannot print money in case they need more liquidity to repay the bonds. This guarantee is missing. When there is a liquidity problem, the fear of not getting paid leads to extended liquidity crisis which spreads in the union, raising the interest rates and leading to solvency crisis. A lender of last resort for the government bond markets could guarantee that the bond would be paid at maturity and avoid the public fear and crisis contagion. In the euro area level this lender can be the European Central Bank, the only unlimited source of liquidity.

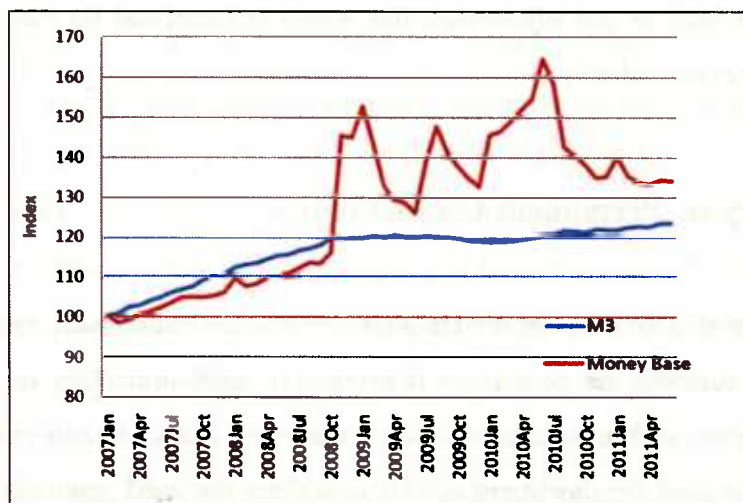
At the present time, the ECB is forbidden to act as a lender of last resort and the benefits that could arise from this function are missing⁸³. Even though at the beginning of the crisis the ECB has acted as a source of liquidity buying government bonds or accepting them as collateral, this issue became controversial as many policy makers believe that ECB should not have this role. The argument is based on different factors. Firstly, on the fear that the ECB by helping the governments may lose money. The truth is that the ECB as a lender of last resort will work more as an insurance and only the fact that it exists will calm the markets and make bondholders feel safe and not try to sell their bonds. It will actually decrease the need for using it as a source of liquidity because everyone will know that their money is safe and that they will be paid. The damage of having a loss in its balance cannot compare with the benefit of financial stability that it can offer in the union. For any case the ECB as the monetary authority of EMU can always print new money. This leads to the second factor against this function of ECB and this is the worry that it could be inflationary for the Eurozone as it may be needed to print new money.

If money stock increases we know that it creates inflation. However this is not the case. When, after 2008, the ECB bought bonds from member states with financial problems, it actually increased the monetary base (money in circulation and deposits at the central bank) and not the money stock (M3). This means that the money that went from the Central Bank to the member states did not go to circulation in the form of credit but stayed in the banks.

Thus there were no effects in inflation by increasing the liquidity. For additional security against inflation, the ECB while buying bonds from the government with liquidity problems it could sell other assets in order to keep the money base and the size of the balance sheet unchanged.

⁸³ De Grauwe P. (2012) "How not to be a lender of last resort", CEPS, 23 March

Figure 9: Money base and M3 in the Eurozone



Source: ECB, Statistical Data Warehouse.

Finally, it is claimed that this function will create the problem of moral hazard for governments. They would be relieved that whenever they take additional risks or put into circulation too much debt and in times of crisis, the ECB will provide liquidity and cover their debt that can be insolvent. The way to deal with this problem could be to impose limits on governments' debt issue. These are the reasons why mainly Germany insists on a conservative ECB concerned about the price stability in euro area, but they are not problems without solution⁸⁴.

As a response to ECB's inability to act as a lender of last resort, the euro area policy makers created other mechanisms to address the liquidity inefficiency of governments. However, the European Stability Mechanism (ESM) which is the permanent new mechanism to act as lender of last resort, cannot deal with this problem due to its limited resources which will not be enough to inspire trust and credibility to bond holders. It is the responsibility of the central bank to make sure that the financial situation in the member states is stabilized and that money is always available.

In addition to the lender of last resort function, at the euro area level exclusively, a supervising-regulating system composed of institutions will help organize the financial system. The fiscal integration would be reinforced if more competencies were assigned at the euro area level like a partial supervision and guidance of national economic and fiscal policymaking. Sometimes the national policies could affect the other member states or not follow a common strategy. Example of

⁸⁴ De Grauwe P. (2011) "The European Central Bank as a lender of last resort" VOX, 18 August

such policies is the labor market (i.e. unit labor cost, wages) or the taxing policies, budget decisions. Opinions and assistance could be offered from the euro-level to the national level relating to these policies and to new reforms and adjustments that would be beneficial for the Eurozone as a whole but also the countries individually.

4.6 Emergency vs. Permanent Legislation

Trying to fix the shortcomings of the Union, the European leaders were targeting the long-term sustainability and focusing on permanent reforms and legislation. This is of course the main objective and purpose of the adjustments that take place lately. But to achieve the long-term efficiency there is a need for short-term actions to address the weak points and challenges and to create a base and backstop where the permanent solutions will rely on. In addition, while crisis continues to exist, small changes in all sectors require fast, instant responses to deal with them and no institutional and treaty reforms. Emergency legislation is something that was missing from the euro area crisis management but something crucial. The European Union was trying to deal with urgent situations by making deep and complex legislative reforms, while fast action was needed. This resulted in ad-hoc and under pressure responses when there was no other choice. Therefore they were addressing the previous stage of the crisis while new challenge was already on the table. The policy makers found themselves behind, trying to catch up with the crisis' pace.

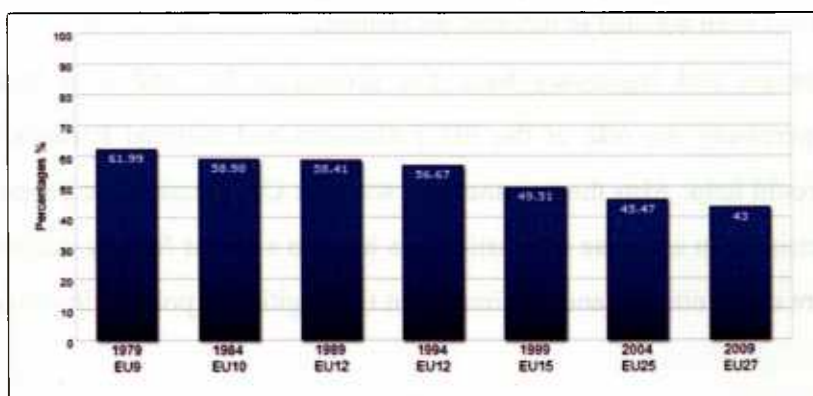
Regarding the banking problems it is necessary to establish first a crisis management system and then a long-term structure and move forward to a banking union. The sustainability of the fiscal union is particularly dependent on the banking system. If the banking sector is fragmented and unstable then fiscal reforms would not give the results that are expected.

5 Democratic Legitimacy

The current European crisis is also a democratic legitimacy crisis for the citizens of EU. Legitimacy is mainly succeeded through the European Parliament the national parliaments, the last being little involved. The guidance of national budgets from the European level (European semester), in addition to stricter fiscal regulations and austerity and the fact that the power of intervention of EU increases, create concerns about the legitimacy of policies and governance. Besides this, countries that receive financial assistance have only the power to agree with memorandums that change their policies and on which they can have no influence. It looks like the Commission, the International Monetary Fund and the ECB are the sculptors of EU at the moment with questionable legitimacy. The democratic deficit becomes more tense when seeing that policies are not very effective⁸⁵.

EU Parliament's influence has increased with the reforms obtaining the power to make its own initiative but without the right to change a recommendation of the Council or to make any decisions, so it remains limited. Even if the role of EU Parliament is increasing by new regulations and by increased spending, it is clear that this is not what the citizens want. Citizens of EU have been keeping a distance from EU voting, denying participating in EU Parliament's elections which is the representative body. This shows clear disappointment for the European idea and lack of interest. The participation of citizens in elections has decreased considerably since 1979.

Figure 10: Turnout at the European elections (1979-2009)

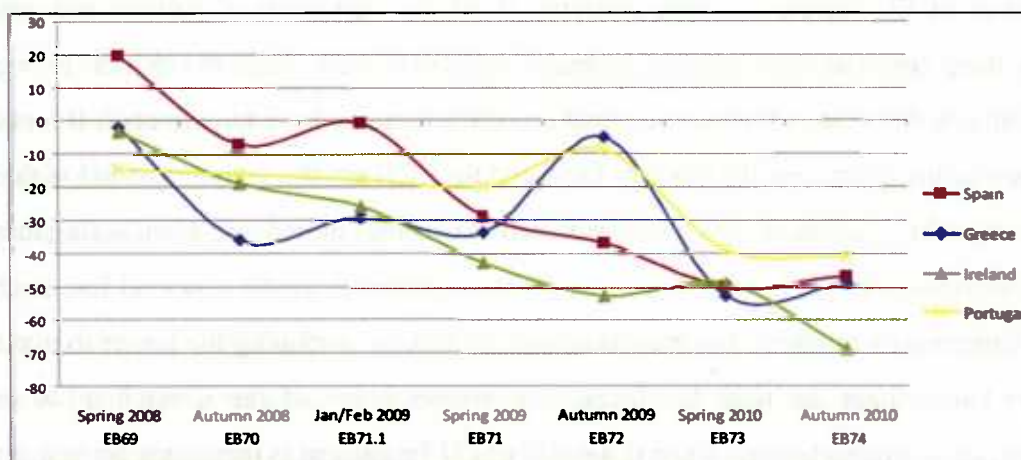


Source: European parliament

⁸⁵ Veron N. (2012) "The challenges of Europe's fourfold union", BRUEGEL 13 August

They lost trust on both European and national institutions. The Eurozone crisis had a negative effect on trust in both institutions: the national government and the European Commission. Spanish citizens' trust in the national parliament since the start of crisis decreased by 67% and that of Irish citizens declined by 65.7%. In Greece, citizens' trust fell by 49% and in Portugal it dropped by 25.2%⁸⁶.

Figure 11: Trust in the national parliament



Sources: Standard Eurobarometers 69-74 and Special Eurobarometer 71.1.

The national parliaments lost some power concerning their most important elements for decision making: labor market structural policies, product market and competition policies and it could be argued that the national parliaments are not involved enough. This is true if we think that in some countries the recommendations with structural reforms under the European Semester coming from the Council, are not even debated in national parliaments.

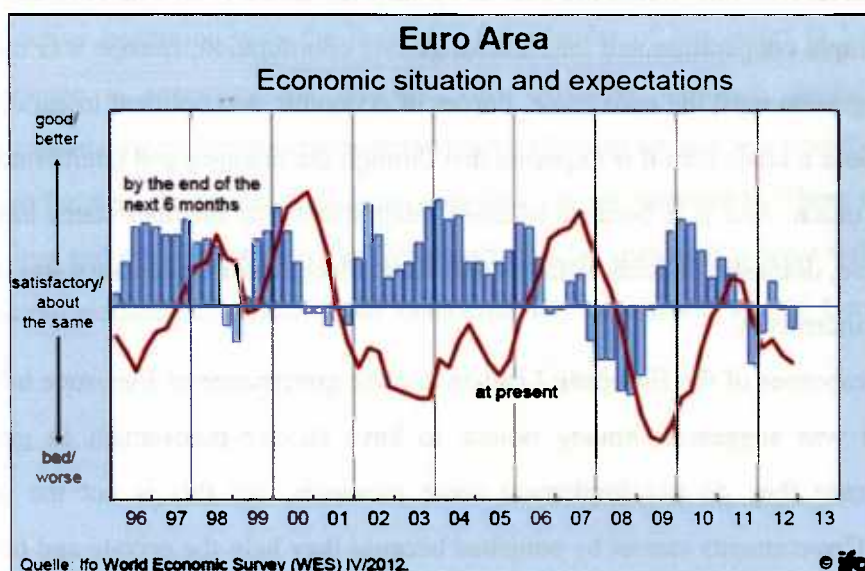
The effectiveness and legitimacy have lost ground in EU and it is hard to be pursued. Theoretically, increasing the role of the EU Parliament and national Parliaments and the links between them could help. Also their connection with the Commission for cooperating, discussing and making decisions. In any case EU institutions have to account for any decision they make that affect the welfare of the citizens and it is important that legitimate policies improve this welfare⁸⁷.

⁸⁶ Roth F., Nowak-Lehmann F. D. Otter T. (2011) "Has the financial crisis shattered citizens' trust in national and European governmental institutions? Evidence from the EU member states, 1999-2010" CEPS, No. 343, June

⁸⁷ Hallerberg M., Marzinotto B., Wolff G. (2012) "On the effectiveness and legitimacy of EU Economic policies" BRUEGEL, November

The economic climate continues to deteriorate and the expectations too. According to the Ifo World Economic Survey (WES) of the 4th quarter 2012, in cooperation with the International Chamber of Commerce: “In Greece, Italy, Portugal, Spain and Cyprus assessments of the current economic situation remain at recession level.” WES experts also continued to assess the situation in Belgium, France, Ireland, the Netherlands and Slovenia as unfavorable. In Germany, the current economic situation was reportedly somewhat poorer than in the previous quarter, but remains satisfactory. The same can be said of Estonia and Slovakia. In Finland, on the other hand, assessments of the current economic situation veered from “satisfactory” to “unfavorable”.

Figure 12: Economic situation in Euro Area



Source: www.cesifo-group.de (World Economic Survey, 2012)

6. Conclusion

The monetary union changed the economies of member states. Member states lost their monetary policy and retained the fiscal policies. With the beginning of sovereign crisis many problems were revealed like the fiscal asymmetries in national level and the governance inefficiency in euro level. The instability of the structure, the debts, the unforgiving markets, the non-compliance of some member states and of course the political pressure led to complex problems and to the potential threat of the Eurozone's collapse. However, economy is not always flourishing and a union is not only for good times. When an individual country faces problems, they become collective. And this should not take us by surprise. Since 1960 when monetary relations had the form of simple cooperation and later exchange rate coordination, Europe was trying to move to monetary integration until the euro came. Forces of economic and political integration followed. If one country faces a crisis then it is expected that through the linkages and interconnectedness it will spread to the union. And it is because of these integrations that member states have to help each other. Of course, domestic policies, reforms and fiscal discipline are necessary and can be achieved with the right incentives.

The first responses of the European Leaders and the governance of Eurozone have been proven inadequate. It was suggested, among others, to have stricter punishment to governments and sanctions in case they do not implement some measures, but this is not the way to achieve convergence. Governments cannot be punished because they help the private and banking sector or because they do not pass to the citizens the decisions of institutions that do not face political sanction⁸⁸.

Unfortunately the failure of governance, the imbalances, the vulnerability of the union and the systemic risks are difficult to resolve. It is a real challenge though to regain trust and stability in the union. The Eurozone does not have its final form yet. It is actually in progress and it is possible that the negative and pessimistic scenarios can change. Effort for adjustment and transformation is needed, hopefully with as less as possible citizens' sacrifices.

Resilience in the system can bring trust back. A fundamental repair of Eurozone is very important. It should make steps towards fiscal consolidation and political cohesion to face the deficits and debts of governments.

⁸⁸ De Grauwe P. (2011) "A less punishing, more forgiving approach to the debt crisis in the eurozone" CEPS, No. 230/ January

A political union may sound too optimistic at the moment but decisive steps should be taken to create a fiscal union and a banking union. This will show that there is political will in euro area to face the problems and establish a strong framework to protect it from future threats. Such a framework is described in this thesis. A fiscal union contains issuance of common debt, national budgetary coordination and a European Monetary Fund for prevention and resolution. Monetary policy is fully centralized but instruments of economic policy stayed at national level creating threatening divergences, making coordination of national economic policies needed. Macroeconomic variables such as debt, imbalances and competitiveness should be centrally monitored. Furthermore, crisis resolution needs a banking union that will cover all the banks of euro area. It would contain supervision, resolution authority and deposit insurance and the ECB should be a much more active institution with the function of the lender of last resort in bond market because the guarantee is necessary for stability. This executive structure should be made accountable to European citizens and therefore democratic legitimacy should be a priority.

It is certain that the way out of the crisis is not easy but it is not impossible. There will always be problems to solve and questions to answer. What will now be answered is what will make the European integration sustainable, efficient and democratically legitimate, and if Europeans are ready to pursue it.

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8. Appendix I

Eurozone statistics

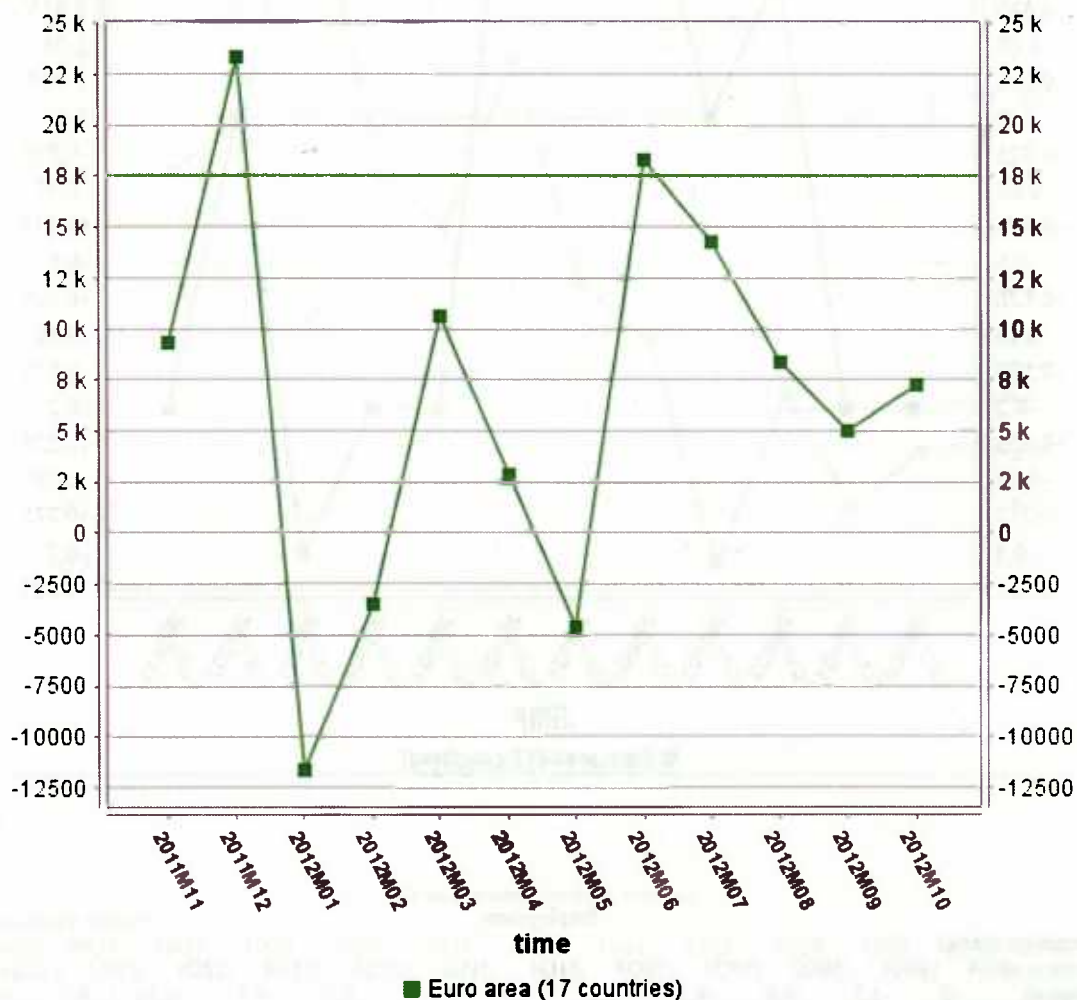
Eurostat 2013

1. Current Account

Balance of payments, current account, monthly data

Million EUR

Total



Balance of payments, current account, monthly data

Million EUR

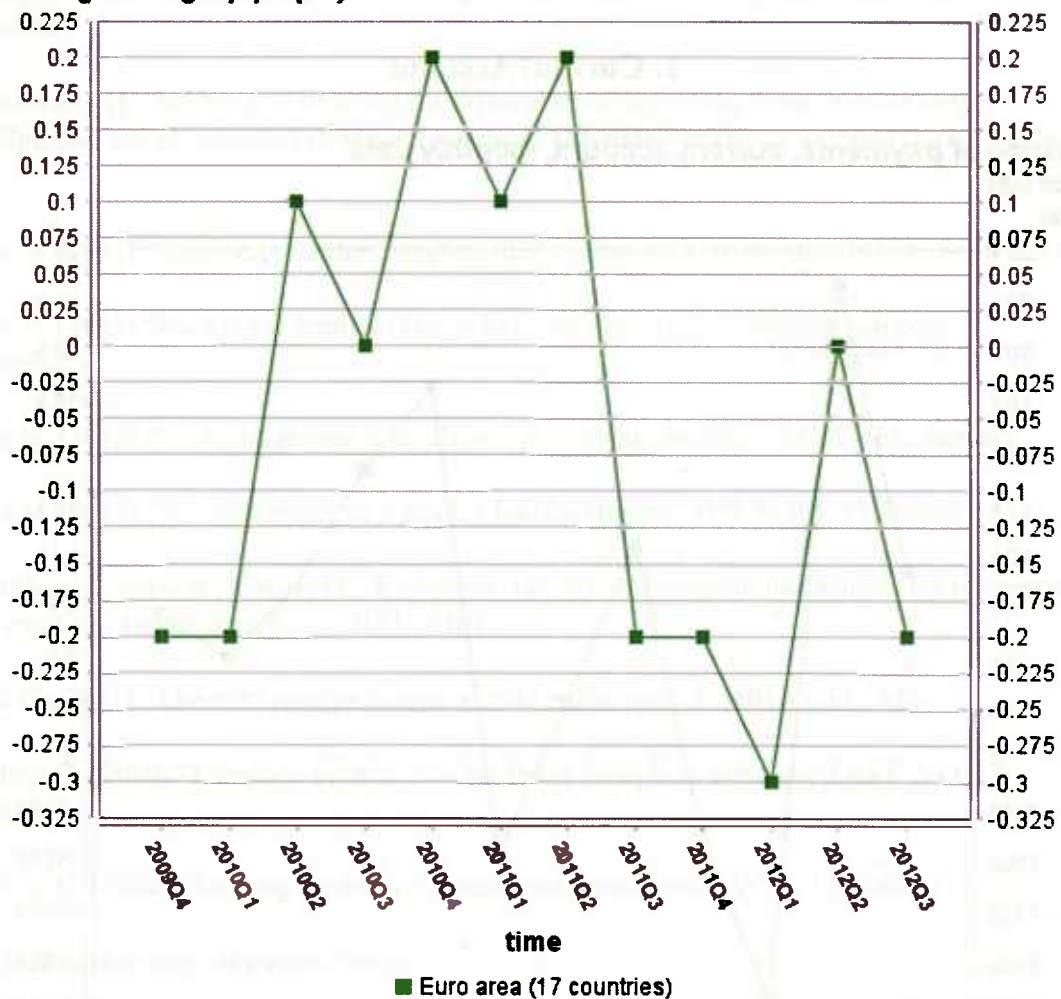
geo/time	11/2011	12/2011	1/2012	2/2012	3/2012	4/2012	5/2012	6/2012	7/2012	8/2012	9/2012	10/2012
Euroarea	9305	23377	-11655	-3548	10580	2862	-4635	18235	14257	8374	5042	7235
update:	14.01.2013											

2. Employment

Employment (NACE Rev.2)

Percentage change

Percentage change q/q-1 (SA)



Employment

Percentage change

geo/time 09Q4

Euroarea

update: 16.01.2013

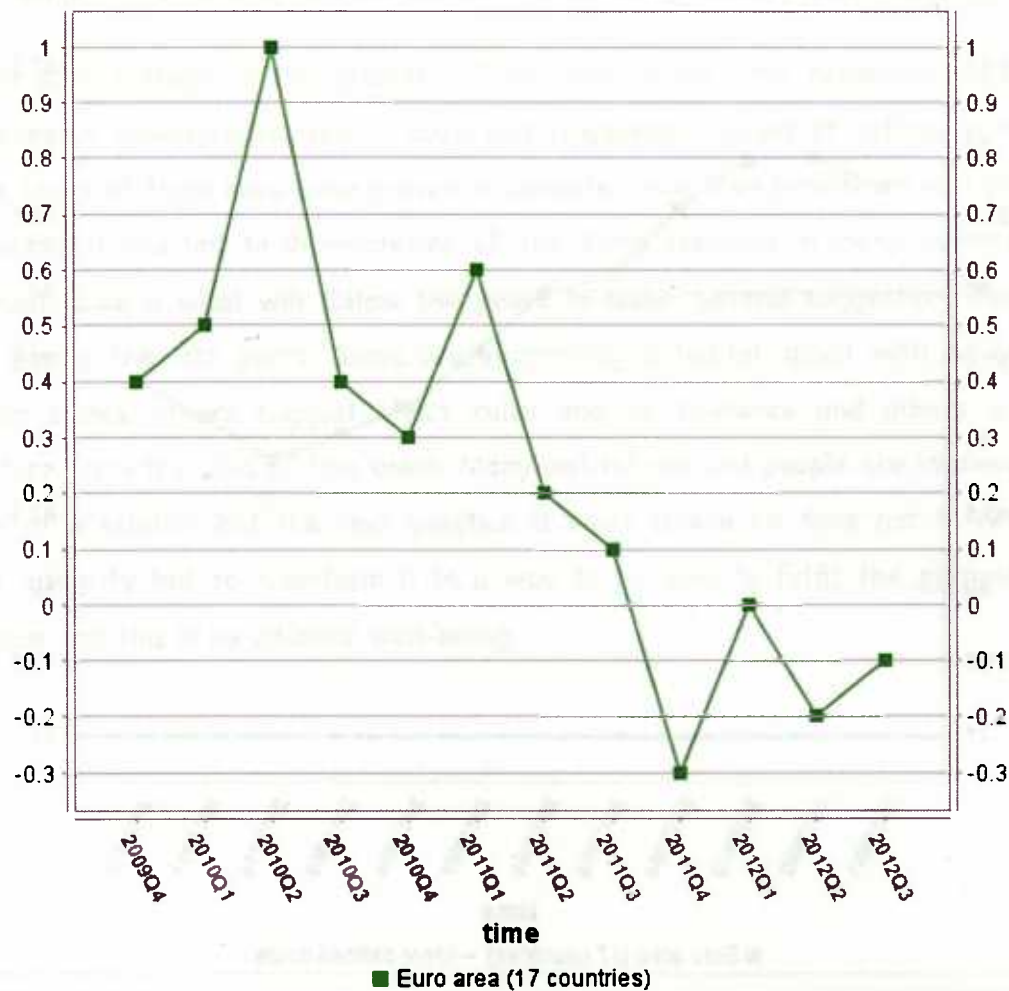
geo/time	09Q4	10Q1	10Q2	10Q3	10Q4	11Q1	11Q2	11Q3	11Q4	12Q1	12Q2	12Q3
Euroarea	-2	-1.3	-0.6	-0.2	0.1	0.3	0.5	0.3	-0.1	-0.5	-0.7	-0.7

3. GDP Growth

Gross domestic product, volumes

Percentage change

Percentage change q/q-1 (SA)



Gross domestic product, volumes

Percentage change

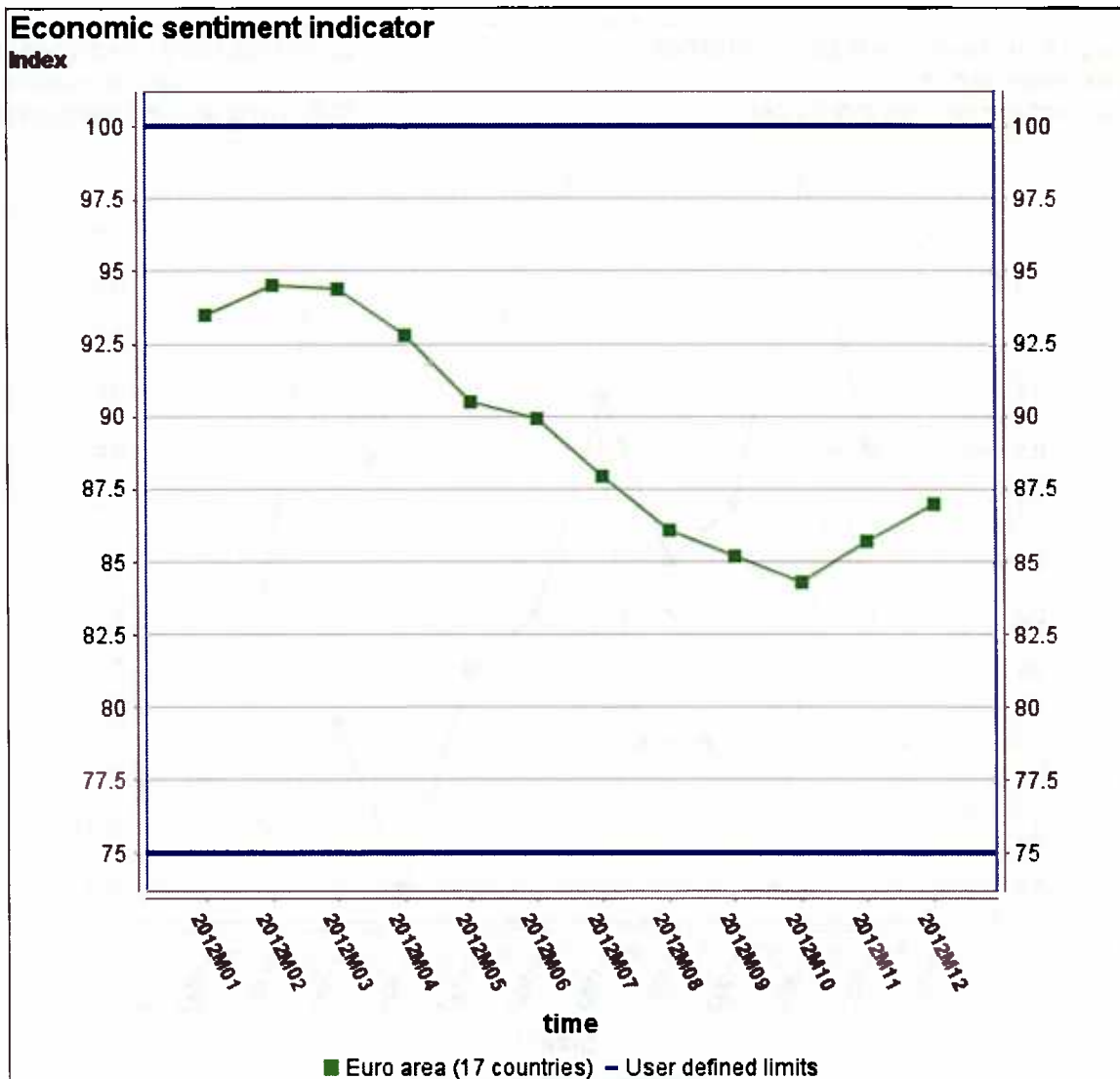
geo\time 09Q4

Euroarea

update: 14.01.2013

10Q1	10Q2	10Q3	10Q4	11Q1	11Q2	11Q3	11Q4	12Q1	12Q2	12Q3
1.2	2.5	2.2	2.1	2.6	1.7	1.3	0.2	0.3	-0.8	-0.8

4. Economic Sentiment



Economic sentiment indicator

geo\time	'12/m1	'12/m2	'12/m3	'12/m4	'12/m5	'12/m6	'12/m7	'12/m8	'12/m9	'12/m10	'12/m11	'12/m12
Euroarea	93.5	94.5	94.4	92.8	90.5	89.9	87.9	86.1	85.2	84.3	85.7	87
update:	14.01.2013											

Summary

Subject of this thesis is the recovery of the current economic recession in Eurozone. The economic downturn started in 2008 and triggered a series of actions in order to face it. Many of them have been proven inadequate since they broadened and prolonged the recession and led to deterioration of the living standard in many countries. The important issue is what will follow the years to come. Several suggestions have been made during the last years. Some are supporting a tighter union with solidarity of member states, others suggest strict rules and no tolerance and others a partial departure from the idea of this union. Many institutions and people are involved in the search of a solution but the real question is what should be done not to retain the union's integrity but to transform it in a way to be able to fulfil the purpose of it's existence and this is he citizens' well-being.





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