Overview

The global financial crisis (now five years on) first manifested itself in Europe when in August 2007, the European Central Bank (ECB) initiated liquidity operations in response to the high exposure of major European banks to losses in the US market in asset-backed securities and the freezing up of the interbank market. This impacted greatly on peripheral countries in particular that had relied on the interbank market to finance development capital. Following the collapse of Lehman Brothers in September 2008, the fallout accelerated rapidly, resulting in bank bailouts across Europe and the Irish government calamitously guaranteeing for two years all deposits and borrowings of six Irish banks.

Crisis of themselves are seldom foreseen or preventable because it is only the 20-20 vision of hindsight that reveals with alarming clarity the build-up of many imbalances that are at their source. And even then there is not fulsome agreement among experts on the most crucial elements of the causes or the necessary remedies to be implemented. Much more so, this is the case in the European Union that has to find solutions to the very complex issues thrown up in the infancy of the multi-country union of the euro zone. There has been no single voice that speaks with authority for the euro area, in part because the distribution of the impact of the crisis has been so diverse from relatively little (Germany, Finland) to catastrophic (Greece).

Inappropriate policies were undoubtedly pursued in the past, but it is worth noting they were not helped by the poor performance of the analytical frameworks used to assess the sustainability of fiscal positions. In analysing the cyclical conduct of fiscal policy from 2002-2007 domestic authorities and international organisations such as the IMF, OECD and the European Commission, in estimating the cyclically adjusted budget balance, failed to take into account the distribution of macroeconomic, financial, and fiscal risks associated with the expansion in external imbalances, credit growth, sectoral debt levels and housing prices. A more prudential and forward looking approach to risk management would have suggested more aggressive actions to accumulate buffers that might help if or when the boom ended in a sudden and disruptive fashion (Lane).

This is not a time to throw stones or cast blame on the numerous possible recipients; nor is it a time for arrogance, chauvinism or dogmatism. But it is time for us all to face the realities as best we can see them and to recognise the design flaws in the euro system of governance that have amplified the magnitude of the impact of inappropriate policies of all kinds that member states have engaged in since 1999. Clearly significant changes must be made to rectify the flaws and establish credible governance.

Now as we enter the fourth quarter of 2012 and the sixth year of crisis, the very existence of the euro and the euro zone as we know it, is under threat as it is clear to all that Europe has failed to come to grips with this most rending crisis. The root cause of the current crisis lies in the contradiction between a single supranational currency and the continuation of national-state-based economic policies (Tommaso Padoa-Schioppa Group, 2012). Because of this, what makes Europe unique has been Europe’s insufficient ability to make authoritative policy and political decisions for the region as a whole. To correct this weakness, Europe must build a fourfold union that would allow such executive decisions to be made. The four components are 1) a banking union; 2) a fiscal union; 3) a competitiveness union; and...
4) a political union i.e. institutional reform to embed democratic accountability more solidly in decision making. (Véron, 2012). This is reflective of van Rompuy’s report to the June 2012 Summit.

It is incumbent on the political and social leaders of all member states, now stratified as debtor and creditor nations, or North and South, to gain a full appreciation of each other’s positions and difficulties and an understanding of how the economic and financial governance in an economic and monetary union differs from national governance. As tensions rise as indeed they have, it is necessary to convey this understanding to the citizens of Europe whose support is crucial in giving leaders the democratic legitimacy that has to date prevented them from taking big decisions at euro area level. There is no doubt that decisions that must be taken to bring an end to this horrendous crisis which is so costly to member states and their citizens, will not be universally liked, but to be accepted they must be understood.

Véron has also pointed out that Europe must pay equal attention to short-term crisis management and long-term initiatives to build a more sustainable system. An exclusively short-term focus could worsen future problems, but a long-term focus, ignoring the most urgent challenges is no less dangerous. Euro area leaders have often given the impression of focussing on long-term legislative and institutional reforms, while neglecting the short-term aspects of the crisis. Short-term responses must be undertaken despite the absence of a specific legal framework. Pragmatic adaptation is often required, while post crisis reconstruction requires higher standards of consistency and accountability. Short-term emergency legislation is different from permanent legislative reform and needs to be recognised as such. There is a significant contrast between the United States which speedily passed emergency legislation and Europe which has persistently focused on long-term initiatives first.

Increasingly greater attention is now being paid to the correction of macroeconomic and financial imbalances, which will require politicians to take and implement hard decisions. There is growing recognition that Member States must agree to reforms of their own national governance as well as those of the euro area. This means embracing a growth and competitiveness union through a more rigorous Europe 2020 process; a banking union to minimise future financial crises and their toxic link to sovereign debt; a fiscal union to ensure proper budgetary management and political union in the form of institutional reform to embed accountability more solidly in decision making. No one underestimates the significant challenges that we all face. It has been argued that the electorate dislike structural reform and that governments are unlikely to go for it. However this reasoning underestimates the wisdom of voters and is not in line with the facts (Buti et al., 2010 in Padoan and van den Noord, 2012). What citizens want is certainty that their leaders are in a position to agree and implement workable solutions.

Of course Europe may fail in its endeavours and the possibility of euro area break-up is real and can no longer be excluded; the outcome of one member leaving or a partial or total disintegration is unknown. Some will argue that we should face this reality now and proceed to an orderly break-up, if indeed this is possible. But Europe has been a process of political innovation from the start. There is no precedent and still no equivalent elsewhere in the world for the kind of supranational institution building that has been
going on in Europe since the 1950s (Véron, 2012). As with all innovation, he says success can neither be taken as a given nor considered impossible.

The reality is that we do not know what unintended consequences this may have and throwing away fifty years of planning and investment is a high cost to bear. The principle of competitive markets based on the Four Freedoms runs the risk of being called into question through a renationalisation of economic policies, possible protectionist tendencies and a potential return to national currencies and competitive devaluations in the context of a euro area break-up. A single currency area break-up would be likely to further accentuate societal divisions in Europe (Tomasso Padoa-Schipps Group: Completing the Euro June 2012).

Some have argued that it would unleash “the mother of all financial crises” (Eichengreen in Lane, 2012) and others warn that we do not have a clear idea of how the exit of a Member State will affect the other Member States. But the falling apart of the euro zone and still much more so, of the EU itself would be a disaster for Europe and a shock for other parts of the world. A member returning to its own currency may have to impose a rigid capital control regime which may also force it out of the EU as well or there could be domino effects leading to Club Med/North Sea Alliance scenario (Friedrich Kübler, 2012). He also points to the enormous impact that the European Community has had on bringing down fascist regimes in Spain and Portugal, the military regime in Greece and the Soviet system in Eastern Europe. The institutional setting has to date been able to peacefully mitigate conflicts between Member States and may serve as a setting for more co-operative and democratic forms of organisation in international politics. We have to balance the huge costs of stabilising financially weak Member States and the huge benefits of existing European institutions.

A break-up of the euro area would be disastrous for Europeans and to a large extent the global economy (Véron, 2012). He goes on to argue that the choices facing Europe’s leaders and citizens are daunting. Their slow pace of decision making has exacted a heavy price from Europe’s economies, societies and families. Greece remains a burning concern. No one can be assured that the euro area would survive its disorderly exit; but there is still no clear enforcement framework available if its trajectory keeps veering off track, as it has repeatedly over the last two years. Investors have good reason to be nervous.

ECB President Mario Draghi has led the politicians with his statement “the euro is irreversible.” This paper discusses the issues that must be confronted for this to be true.

Europe at last showing signs of taking the big decisions

A clear understanding of the causes of the crisis is a prerequisite for success. To date, the policy debate has not been helped by the characterisation that high and unsustainable public debt was the sole cause of the crisis, giving voice to the simple solution that the remedy was fiscal austerity. This indeed is true for some countries; but the pre-crisis record of exemplary fiscal rectitude failed to prevent the economic crisis that developed in Ireland and Spain. There were indeed other causes that require more deep seated remedies, but which got little attention in the protracted inter-governmental approach leading to the fiscal compact. It is a widely held view by economists that severe fiscal retrenchment in countries
entering recession is likely to drive them into a deep depression thus exacerbating rather than solving their sovereign debt problems. Growth policies are also needed.

In part the slowness of the European Union to fully grapple with the root causes of the crisis was the shocking revelation by the new Greek government in October 2009 that it was revising upward the budget deficit forecast from 6% of GDP to 12.7% and that revisions to previous years were also being revised sharply upwards. This revelation of extreme violation of the euro’s fiscal rules by Greece shaped an influential political narrative of the crisis, which laid the primary blame on fiscal irresponsibility of the peripheral nations, even though the underlying financial and macroeconomic imbalances were more important factors (Lane, 2012).

But thinking has moved on. Unlike previous summits, the June Summit made some small but tangible progress, not least because of the continuing pressure on funding Spanish and Italian debt. There was a compact for growth and jobs, recognising growth is an essential element in exiting this crisis. There was affirmation of the imperative to break the vicious circle between banks and sovereigns and the need for a single supervisory mechanism for the banking system with proposals before the end of 2012. There was also commitment to do “what is necessary” to ensure financial stability of the euro area, in particular by using the existing EFSF/ESM instruments in a flexible and efficient manner to stabilise markets. It was agreed to allow the eurozone’s rescue funds, the European Financial Stability Fund (EFSF) and the European Stability Mechanism (ESM), to be used to recapitalise directly undercapitalised banks rather than lend the money to sovereign governments to bail out their banks, as was the original terms of the Spanish bailout. This is an essential and welcome step towards breaking the lethal link between bank debt and national sovereign debt, which is at the heart of the crisis and continues to threaten the very existence of the euro.

The crucial role of the ECB

There have been many calls for the ECB to perform the role of lender of last resort to sovereign debt, as it does to the banks. Up to the crisis, the ECB’s role had been narrowly and successfully played as the custodian of price stability. In October 2008, it had no problem in massively increasing liquidity to save the banking system by acting as lender of last resort. However, when the sovereign debt crisis erupted, the bank was gripped with hesitation (De Grawe, 2012) and operated a stop-and-go policy in the provision of liquidity to the government bond market. Because in a monetary union governments issue debt in a currency over which they have no control (“foreign”) they cannot guarantee to the bondholder they will always have the necessary liquidity to pay out on maturity.

The absence of a guarantee makes sovereign bond markets in a monetary union prone to liquidity crises and forces contagion. When solvency problems arise in one country, (Greece) bond holders sell bonds in other bond markets, triggering a liquidity crisis in these markets. The consequent increase in government bond rates turns the liquidity crisis into a solvency crisis, because there is an interest rate high enough that will make any country insolvent. The characteristic failure of these dynamics is that distrust can push a country in a self-fulfilling way into a “bad equilibrium” characterised by high interest rates, recessionary forces, increasing budget problems and an increased probability of insolvency. The
most important argument for mandating the ECB to be lender of last resort in the government bond markets, is to prevent countries from being pushed into a bad equilibrium (De Grawe, 2012).

Some have real concerns that the role of the ECB as lender of last resort in the sovereign bond market would lead to inflation. In a crisis situation this is unlikely, because agents want to hold cash for safety reasons. If the central bank does not supply cash it turns the financial crisis into an economic recession or depression as agents sell assets in the scramble for cash (De Grawe). In like manner, banks have piled up liquidity provided by the ECB without using it to extend credit.

The genuine concern that governments may be encouraged to stall the necessary corrective action that they may take (moral hazard), should be addressed in part, by conditionality attaching to ECB interventions. However, it is recognised that a benign market response to ECB intervention could tempt some governments to relax their consolidation efforts. Countries that share a monetary union must find the trust needed to sustain popular acceptance of both the very tough policies states in trouble must undertake and the resources required from stronger states to buy them time.

On the other hand, there are fears that too much fiscal consolidation could be self defeating because of the impact on growth. There is too much fiscal consolidation if it would push the economy towards a “bad equilibrium” where there is simultaneous occurrence and adverse feedbacks between high and growing fiscal deficits and debt, slumping economic activity and plummeting confidence. Remedies generally include financial firewalls to contain contagion and structural reforms to boost growth expectations (Padoan and van den Noord, 2012). Firewall action can be very powerful in the short-term but will fade away if not supported by further confidence building measures. The combination of structural reform, fiscal consolidation and financial policy will likely deliver higher growth.

It is obvious there are new challenges for the ECB including self-understanding and the functioning of the institution. In the early years of its existence internal conflicts were never disclosed to the public. This clearly has changed and has resulted in resignations. It is known there are currently differences between the President of the ECB, Mario Draghi and Jens Weidman president of the Bundesbank. Up until now the ECB largely followed the philosophy of the Bundesbank that monetary stability was the primary responsibility of central banking. Today many observers feel that the majority of the Governing Board thinks other objectives like growth, employment and the preservation of the euro zone in its present shape are no less important (Kübler, 2012).

ECB President Mario Draghi’s announcement of 7 September that the ECB would offer to purchase euro zone countries’ short-term bonds in the secondary market, known as outright monetary transactions (OMT), offers a significant tool to calm Europe’s distressed sovereign debt markets. This is the ECB leading the politicians who on the one hand as recipient countries have difficulty with the strict conditionality of the bonds; and on the other the reservations of those countries who still bear most of the risk of default that fear the bonds will diminish the determination of the recipient countries to carry out reforms. The unlimited fire power this gives the ECB to fight off speculative attacks is the shelter necessary to give countries at risk the time to make reforms that will allow them to return to the market. It is hard to see what else the ECB could do to ensure financial stability by insisting with practical
back-up that the euro is irreversible. It is for the political leaders above all and the other EU institutions to act as decisively as the ECB to ensure they grasp this opportunity to make real progress. Politicians and citizens must understand that much painful consolidation still needs urgent implementation.

An outline of what further actions need to be taken was given at the June Summit. The strangely, but aptly titled Van Rompuy paper Towards a Genuine Economic and Monetary Union presented to the Summit gives an outline of the vision for EMU to ensure stability and sustained prosperity, which must be developed. The report proposes a vision for a stable and prosperous EMU based on four essential building blocks: an integrated financial framework; an integrated budgetary framework; an integrated economic policy framework; and democratic legitimacy and accountability.

What has emerged from the crisis is that management of a single currency area, with sub optimal conditions, is a more complex task than a single monetary policy and some mild form of fiscal oversight. Macroeconomic imbalances in terms of competitiveness, internal balance of payments imbalances, weak domestic demand in strong economies, and the free flow of capital across borders are of much more profound consequence than the regional imbalances that occur within an individual country – and therefore require appropriate governance mechanisms. At last there is the possibility to implement policies that will address these issues.

**Fiscal Union**

The sovereign debt crisis has made it very clear that the “E” of EMU, the economic governance of monetary union needs to be strengthened to avoid the growing intra-euro area imbalances and subsequent systemic crisis over the past decade. This has accelerated a broad European reform agenda which includes strengthening the fiscal policy framework, establishing a new European financial supervisory architecture, putting in place crisis management architecture, accelerating growth and adjustment enhancing structural reforms in labour and goods markets and creating a procedure for identifying and addressing newly emerging imbalances (Smets, 2012). The above list covers all aspects of union including banking and elements of political union, and is inter-linked as was suggested above. In this section, the concern is fiscal and budgetary discipline and economic governance.

Some would argue for a euro area finance ministry with veto rights over national budgets that could threaten the euro area substantially, (Marzinotto, Sapir and Wolff, 2011), which would imply significant transfer of sovereignty and Treaty change. While such a move would take several years, such moves are in contemplation as a quid-pro-quo for short-term measures such as ECB support for distressed countries. In successful crisis prevention, it is useful to distinguish two types of crises, both of which include fiscal stress: 1) a fiscal crisis leading to a banking crisis as for example Greece; and 2) a banking crisis leading to a fiscal crisis as for example Spain or Ireland (Bakerowicz, 2012). Both result in large credit booms which fuel spending booms either by governments or by consumers and business. They are discussed under two headings, Fiscal and Budgetary Discipline and Economic Governance.
**Fiscal and Budgetary discipline**

There is no doubt of the need for fiscal and budgetary discipline, which are the foundation for sustainable growth. The build up in public debt and deficits, which have escalated as a consequence of the crisis in many member states is not only unsustainable from a market funding point of view but is injurious to the prosperity of the citizens whose tax revenues are diverted to debt servicing costs rather than public service provision in health, education, growth enhancing infrastructure and social services. As we have seen only too clearly, countries with high debt levels are very vulnerably exposed to economic downturns and do not have the fiscal space to trade through them. As the Van Rompuy report points out, the financial and debt crisis has underlined high levels of interdependence, particularly within the euro area.

If we are to give practical effect to the calls for solidarity, then those who are in need of assistance must be prepared to allow those who are in a position to give it, a greater say in their fiscal and budgetary plans. The original Stability and Growth Pact recognised in name only the need for a common fiscal policy to complement the single monetary policy. The narrow surveillance metrics of an annual deficit of no more than 3% of GDP and a debt ratio of 60% of GDP were flouted by France and Germany in the first years of monetary union and the excessive deficit procedure was never invoked. Indeed the debt was never a focus, even when some countries had debts well in excess of 60% of GDP. Had there been a deeper and more effective surveillance in some member states’ budgetary policies by the European Commission from the start of the single currency, it is likely that their current difficulties would have been substantially less onerous in this economic crisis. Fiscal consolidation is necessary because the effect of financial policies to reduce interest rates (bond buying and assistance programmes) is likely to fade if the interest rate fall is not made permanent by a lower debt ratio (Padoan and van den Noord, 2012).

The new measures agreed at the end of 2011, namely the so called “six pack“ Council directive and the “two pack“ regulation form the basis of a much tighter surveillance of fiscal policy. These came into effect in December 2011 and should result in significantly tighter adherence to the SGP, which will ensure much greater coordination of fiscal policy. The six pack provides for ex ante guidance of fiscal policy in setting out medium-term budgetary objectives and ensuring that:

- preventive action is taken by requiring public expenditure growth to be no higher than a member state’s potential growth rate; better enforcement of the debt and deficit rules, resulting in an interest bearing deposit amounting to 0.2% of GDP convertible to a fine for persistent non-compliance; annual debt reduction of one-twentieth of the excess debt over 60% of GDP; reverse majority voting to ensure more automaticity.

The Treaty on Stability, Convergence and Growth is a further important element in the reform of the EU’s fiscal and budgetary policy, giving a coherent picture of how fiscal policy should be conducted in the future. The articles relating to the fiscal compact provide a new improved framework for the conduct of fiscal policy at member state level. They represent a further elaboration of the set of fiscal
procedures set out in the six pack of reforms that came into effect in December 2011. The key principle is that fiscal policy can only be effectively used for macroeconomic stabilisation if the underlying medium term fiscal position is sustainable (Lane). The role of sound fiscal policy in national macroeconomic stabilisation is especially important in the euro area where running an expansionary monetary policy or currency depreciation are not available to individual member states. From an economic governance viewpoint, running an unsustainable fiscal policy runs the risk of contagion and resort to bailouts that have characterised some elements of this crisis.

The fiscal compact rightly (and helpfully) concentrates on a structural deficit measure of no more than 0.5% of GDP over the cycle for countries with debts of over 60% of GDP and of up to 1% for those with debts below 60%. There is also a specified time for reducing debt to 60% of GDP, so that the excess above that ceiling is eliminated at an average of $\frac{1}{20}$th of the excess deficit each year. Confining the measure to a structural deficit removes the pressure on governments that are trying to run large enough surpluses in good times which may be masking an underlying structural deficit. In this way governments are more likely to have built up a sufficiently large buffer to offset against an adverse economic shock.

There is recognition of the technical difficulty in calculating a structural deficit, which has met with some adverse comment, but the Directive on the budgetary frameworks of member states and the regulation relating to monitoring and correcting excessive deficits suggest the Commission envisages an ongoing debate on the measure with individual member states and their independent domestic forecasters. This makes good sense, given the poor diagnosis by the main economic agencies over the past decade, referred to above. The fiscal compact contains two innovations (Ziller, 2012). The first is that budgetary deficits should be prohibited by member states’ laws and the second, competence is given to the European Court of Justice to rule on whether a member state has infringed on its obligation to enact or comply with the appropriate legislation. It is noteworthy that the primary source of fiscal discipline is domestic (Lane, 2012). The fiscal compact rules are set out in domestic legislation and oversight is by a national independent fiscal council. This gives greater political legitimacy, although there is external surveillance and the threat of sanctions for non compliance.  The Van Rompuy report insists that the smooth functioning of the EMU requires not only swift implementation of these agreed measures but also a qualitative move towards a fiscal union.

It is notable that the Treaty does not seek to influence the level of government expenditure in a member state, which is a matter for national governments; it does however require that the level of spending is broadly matched by the level of revenue collection over the medium term. Van Rompuy should be supported by Member States when he says in the context of greater pooling of decision making on budgets commensurate with the pooling of risks, that effective mechanisms to prevent and correct unsustainable fiscal policies in each Member State are essential. Upper limits on the annual budget balance and on government debt levels could be agreed in common and issuance of government debt beyond the level agreed in common would have to be justified and receive prior approval.

The fiscal compact could become a gateway to participation in other key policy instruments of the Union, thus further cementing good fiscal and budgetary discipline into member states. Already, access to bailout funds from the ESM is conditional on a member state signing the Treaty. In the future, other
instruments may equally rely on the necessary trust and commitment to fiscal discipline brought about by the fiscal compact. The issue of common debt and the introduction of joint and several sovereign liabilities is only feasible if the governments of member states can be trusted to refrain from excessive borrowing. Greater fiscal federalism could be built on this underlying cornerstone of fiscal discipline allowing perhaps EU level sharing of some tax revenues or EU level financing of unemployment benefits.

A more robust fiscal discipline structure, which would lead to a greater level of trust between member states, would allow for greater fiscal union and put the European Union on a stronger footing to face future adverse shocks with more strength and practical solidarity.

It is recognised that while the fiscal compact offers a robust method of fiscal conduct it is by no means a solution to the current sovereign debt crisis, which above all needs policies to generate growth.

**Economic Governance**

The strengthening of the Stability and Growth Pact and the fiscal compact are essential elements of economic governance. However, as alluded to earlier, fiscal imbalances were only a part of the economic crisis. There were other more significant macroeconomic imbalances that in some member states were of more importance than the fiscal balance. Macroeconomic imbalances such as loss of internal competitiveness, euro area balance of payments deficits, weak domestic demand in strong economies, construction bubbles low productivity and a financial collapse were all contributory causes of the sovereign debt problem.

The Commission has pointed out member states have made divergent economic choices leading to competitiveness gaps and to major macroeconomic imbalances within the EU. This is, perhaps, an over-simplification. Divergent choices are often due to radically different conditions: political; economic; social; geographical. The single currency and a single interest rate are also factors. Economic choices must be consistent with a common goal, which has not been well recognised as this crisis has demonstrated.

To the extent that competitiveness gaps were due to poor choices, the Lisbon Agenda notionally tried to tackle the insidious creeping divergence between economic performances but the governments of member states gave it scant regard. In 2011 a major innovation in economic governance was introduced with the initiation of the European Semester process in which the European Economic and Social Committee is a full participant. The Annual Growth Survey, published towards the end of each year, launches the European semester of economic governance, as part of the agreed enhanced economic governance legal framework ("the six pack"). The AGS sets out what the Commission believes must be the EU’s priorities for the coming 12 months in terms of economic and budgetary policies and reforms to boost growth and employment under the Europe 2020 strategy. Once endorsed by the March European Council, these priorities have to be taken into consideration by the Member States in their national policies and budgets.

The EU’s new rules on economic governance contained in the six pack have two legs: fiscal and macroeconomic surveillance. Under the new rules on economic governance the Commission published
the first ever annual Alert Mechanism Report (AMR) on 14 February 2012 under the Macroeconomic Imbalance Procedure (MIP). The conclusions of the AMR are discussed in the Eurogroup as far as eurozone countries are concerned and in the Council of Economic and Finance Ministers for all EU countries. The AMR is based on a scoreboard of indicators designed to identify areas of economic instability in such areas as loss of competitiveness, a high level of indebtedness or asset price bubbles, credit growth, current account balance, etc., reflecting the fact that excessive imbalances typically pop up in a number of sectors at the same time (Smets, 2012). The 2012 AMR identified 12 EU member states, in addition to those under EU/IMF financial support programmes, whose macroeconomic situation needed to be analysed in more depth. If the AMR reveals harmful macroeconomic imbalances exist, then under the preventive arm of MIP, the European Commission and the Council of Ministers may adopt recommendations to correct the tendency towards imbalance and in more serious cases it can trigger the corrective arm, the Excessive Imbalance Procedure.

This attempts to make the surveillance of macroeconomic imbalances more on a par with fiscal surveillance. It is recognized that this is much harder to do because the areas of reforms needed cover many diverse areas and come within the remit of many directorates-general and can have less quantifiable outcomes than those in the budgetary sphere. Reforms, too, may be of a longer duration and have less urgency for more short-term thinking politicians. But recent work by the OECD suggests that growth effects from structural reform will only materialize with a lag are exaggerated (Padoan and van den Noord, 2012). Financial markets reward the increased growth potential which can yield positive wealth effects on demand even in the short-term.

In its latest Alert Mechanism Report (AMR) the Commission explains that the AMR is the first step in implementing the new surveillance procedure for the prevention and correction of macroeconomic imbalances procedure (MIP) and its role is to work as an initial screening device. The AMR aims to provide country-specific comments on the reading of the scoreboard. On the basis of follow-up in-depth studies the nature of imbalances is expected to be determined and appropriate policy recommendations will be proposed either under the preventive or the corrective arm of the procedure. Countries are assessed by looking at the evolution of indicators over time as well as taking into account the most recent developments and outlook. The assessment takes into account also a combination of additional relevant information and a wider set of indicators.

Consistent with these intentions to take into account a combination of additional relevant information and a wider set of indicators, the European Commission and its MIP could benefit from the experience and studies of other international institutions such as the IMF, the World Bank and the OECD. The country-specific reading of the scoreboard and the follow-up studies of the nature of imbalances could benefit from the in-depth country-specific analyses provided by the IMF Country Reports under Article IV consultations. The country-specific recommendations could also take into account the existing studies, conducted by the OECD and IMF.
The Commission reports may make premature conclusions about a country’s loss or gain in cost and price competitiveness based on appreciation or depreciation of the country’s real effective exchange rate calculated on the basis of HIPC deflators. For example the scoreboard includes the real effective exchange rate (REER) based on HICP deflators. However, alternative approaches to the REER should also be considered. For example the IMF reports usually make use of several methods/approaches for estimating a country’s REER appreciation/depreciation: the CGER-type estimates, macroeconomic balance approach, external sustainability approach, and equilibrium real exchange rate methodology. As a result a more balanced and precise understanding of a country’s loss or gain in competitiveness is acquired.

The peer review process should learn from and take into account the experience of other relevant institutions that have been conducting reviews for many years and have already gained strong expertise in this field.

Over the last two years, we have become concerned at the diminution of the Community method in favour of inter-governmental approach. We remarked above that the conduct of governance in a single currency area with non-optimal conditions is a more complex process than was fully realized or leaders were prepared to acknowledge, at the start of monetary union. While not wishing to undermine the value of some of the outcomes of the inter-governmental approach, it has added to complexity. As noted by Bruegel policy brief, March 2012, the basic governance model has been retained while new components have been added either at euro-area level (ESM) or at EU level (European Semester) or in ad-hoc formats (the Euro-plus pact, the Treaty on Stability, Coordination and Governance). The decision making mechanism is more complex and difficult to manage, bringing into question its perception by and accountability to citizens.

**A Banking Union**

The decision to leave banking supervision at national level was questioned as far back as 1991 when the single currency architecture was being built. Then it was pointed out that a centralised bank supervision authority with wide powers would be more able to operate above national political pressures in acting decisively to prevent a failing bank from continuing to operate in an unsound manner and that in the case of monetary management it may be worthwhile for national governments to cede power to the centre in order to “save them from themselves.” There was also an inherent contradiction between pan-European banking and exclusive national responsibility for bank crisis resolution. After the onset of the crisis multinational banks retrenched from their foreign investments to the detriment of their host countries. Experience of the crisis has shown that a fragmented approach to banking policy makes it more difficult to minimise losses to taxpayers.

As in other areas, the crisis has exposed other weaknesses. The integrated European financial market has entered a process of fragmentation, with the free flow of capital ceasing to flow between North and South. Cross border banks have become national banks again in the crisis as they depend on national governments for support. This has increased the exposure of the ECB that has become the financial intermediary replacing the interbank market. Banking and sovereign solvency has become hopelessly
entwined and it is now clear that a fragmented approach to banking policy renders it more difficult to minimise losses to tax payers. Also individual countries may be prevented by neighbours from imposing losses on bond holders for fear of contagion as happened in Ireland; or if they do impose losses, other domestic banks are at risk of being disadvantaged in the single financial market as was a factor in Denmark. A banking union has emerged as the key way to respond to the incompleteness, though some countries outside the euro area see it as an exclusively euro area necessity.

Pisani-Ferry, Sapir, Véron and Wolff, (2012) set out the main building blocks for a banking union.

First, European banking regulation. This area is substantially already harmonized but still needs progress to achieve the vision of de Larosière’s single rule book. They suggest the introduction of a European banking charter to allow European banks to compete on a truly level playing field.

Second, European supervision. This is required by both the need to effectively supervise banking operations that are integrated on a cross border basis and to counter the incentives for national supervisors to overlook excessive risk-taking by banks in their jurisdiction if deposit insurance is moved to the European level. The European advisor would need direct authority over supervised entities.

Third, European deposit insurance. The scheme would be financed by contributions from the participating banks, which would essentially pool risk across banks in all participating countries. This would increase the potential for dealing with country specific, region specific or bank specific crises. As deposit insurance can never cover all risk scenarios it would need to be backed by a second, inherently fiscal line of defense, entailing some level of European-level fiscal capacity.

Fourth, a European resolution authority. This is needed to prevent the combination of national crisis management decisions from resulting in excessive and avoidable costs to taxpayers in Europe including the issue of burden sharing with creditors.

Pisani-Ferry et al make the important point that in a steady state the different pillars of a banking union cannot be separated from each other, nor are they fully separate from parallel advances towards fiscal union and political union. If not backed up by fiscal support, a European deposit insurance scheme would not help deal with major banking crises. Without a centralized resolution authority, real-time decisions would be made in a disorderly manner at the national level as committees based on consensus could not act at the required speed.

Without European supervision, moral hazard would undermine the common insurance scheme and make it prone to distributive biases. It is only by pooling competences in all areas that the banking union would be able to strengthen the system. This does amount to a significant devolution of responsibility to the European level, which makes it imperative to strengthen the accountability and legitimacy of European-level decision-making from a democratic standpoint.

The financial framework is a key building block identified in Van Rompuy’s report; the crisis having revealed structural shortcomings in the institutional framework for financial stability. This is of particular importance to the euro area because of the deep interdependence resulting from the single currency.
Addressing these shortcomings must be done whilst preserving the unity and integrity of the single market for financial services. Therefore, the report suggests that the framework should cover all EU Member States whilst allowing for specific differentiations between euro and non-euro area member states in areas linked to monetary union rather than the single market.

Van Rompuy argues that building on a single rule book, an integrated financial framework should have two central elements: single European banking supervision and a common deposit insurance and resolution framework.

Van Rompuy rightly urges that the current architecture should evolve as soon as possible towards a single European banking supervision system with a European and a national level so as to ensure the effective application of prudential rules, risk control and crisis prevention throughout the EU. This would ensure that supervision of banks in all Member States is equally effective in reducing the probability of bank failures and preventing the need for intervention by joint deposit guarantees or resolution funds. The ECB has such powers of supervision conferred on it by Article 127(6) TFEU over banks in the euro area. What supervisory authority would be acceptable to non-euro area Member States will require resolution.

Further measures suggested by Van Rompuy are:

A European deposit insurance scheme could introduce a European dimension to national deposit guarantee schemes for banks overseen by the European supervision. This would give credibility to existing arrangements and give assurance that eligible deposits of all credit institutions are sufficiently insured.

A resolution scheme, primarily funded by the banks could provide assistance in the application of resolution measures to banks with the aim of orderly winding-down non viable institutions and thereby protect tax payer funds.

Such schemes could be set up under a common resolution authority and would greatly reduce the need to make actual use of the guarantee scheme. Von Rompuy suggests that to be credible the scheme would require access to a solid financial backstop and suggests the ESM could fulfill this role.

**Growth and Competitiveness – Europe 2020 Strategy**

Until the global crisis, Europe’s disappointing growth performance was seen as merely a relative concern vis-à-vis more successful countries such as the US. Europe enjoyed already high living standards and benefitted from longer holidays. Controversially, Oliver Blanchard (2004), suggested that lower income per capita was perhaps the result of social choice. In any case, Europe successfully fostered the catching up of least developed areas in EU (Gill and Raiser, 2011).

But the global crisis altered this benign picture in three fundamental ways (Darvas and Pisani-Ferry, 2011). Firstly, growth is of the utmost importance for both public and private deleveraging and for reducing the fragility of the banking sector. Financial repression (governments persuading financial institutions to take their debt), inflation and occasional default have been other ways of exiting a crisis,
but Europe does not want to take this route. Without growth Europe is at risk of struggling permanently with debt sustainability and vulnerable to future shocks. Without growth the sustainability of the European social model would be brought further into question. Secondly, convergence within the EU has brutally stopped and in the South has moved into reverse. Thirdly, the sovereign debt crisis may put Europe at risk of being shunned by investors.

The Van Rompuy report rightly says that “in an economic union, national policies should be oriented towards strong and sustainable economic growth and employment while promoting social cohesion. Stronger economic integration is also needed to foster coordination and convergence in different domains of policy between euro area countries, address imbalances, and ensure the capacity to adjust to shocks and compete in a globalised world economy. This is essential for the smooth functioning of the EMU and is an essential counterpart to financial and fiscal frameworks. It is important, building on the principles spelled out in the European Semester and the Euro Plus Pact, to make the framework for policy coordination more enforceable to ensure that unsustainable policies do not put stability in EMU at risk.

Within the European Semester process, the intense surveillance procedures lead up to the adoption by the member states of Stability or Convergence Programmes (on public finances) and National Reform Programmes (on structural reforms and growth enhancing measures). These programmes link very closely to the Europe 2020 strategy which has ambitious EU-wide and national targets to be achieved by 2020 in the areas of jobs, innovation, education, energy and social inclusion. The importance of implementing these commitments at national level is imperative, because by their very nature they are the policies that will lead to a competitive Europe through smart, sustainable and inclusive growth. Internally within the European Union they will reduce the gaps in productivity and competitiveness between member states that gave rise to the imbalances that are at the root of this economic crisis.

The Europe 2020 strategy aims to ensure that the European Union can compete in ever increasing global competition. The country specific recommendations provide an EU input into national policy making and in the context of the European semester process the expectation is that reforms that are agreed must be implemented. Implementation is monitored by the Commission and by member states through a rigorous and ongoing peer-review process. There are sanctions under the MIP for member states which do not comply. In 2011, the process was still at an experimental stage and even though implementation of the reform programmes was very disappointing, no action was taken. For the credibility of the process this must change or the much needed reforms that are the key to balanced growth in the Union would be in danger of becoming as ineffective as the reforms of earlier years under the Lisbon Agenda.

We should bare in mind that moral suasion can be a far more effective method of compliance and we have seen in the past larger countries have been the first to ignore commitments under the SGP. As Umberto Burani in his Opinion in 1997 noted under the SGP that a sanctions regime provides for derogations for temporary and exceptional circumstances implies a reference that it refers to a single Member State deviating due to circumstances beyond its control. However he points out that the 1972 oil crisis for example which affected a number of Member States in exceptional circumstances but
whose effect could not be remedied in the short term. This situation was not taken into consideration in the SGP for example and it is not always possible for governments to conduct their economies as they would like to. Therefore sanction can be a very inappropriate instrument.

The European Council in March 2012 said that Europe 2020 is the Union’s strategy for jobs and growth and its comprehensive response to the challenges it faces. In particular, the five targets set out for 2020 remain fully relevant and will continue to guide the actions of the member states and the Union to promote employment. Improve the conditions for innovation, research and development, meet our climate change and energy objectives, improve education levels and promote social inclusion in particular through the reduction of poverty. However the Council concluded that the efforts undertaken to date remain insufficient to meet most of these targets. It is therefore urgent to concentrate on the implementation of reforms, with particular attention to measures which have a short-term effect on jobs and growth.

The EESC’s message to the March 2012 Council was an endorsement of the emphasis that the AGS put on the lack of proper implementation of reforms at the national level. It is of great concern that commitments set in the National Reform Programmes in 2011 are insufficient to meet most of the EU-level targets; in light of the growing concern that Europe 2020 targets will not be met, it is our belief that the EESC bears an even greater onus to inform citizens in the member states of the commitments that their governments have undertaken and to point out in dialogues with national economic councils or other relevant bodies any shortfalls that need to be redressed.

Darvas and Pisani-Ferry (2011) endorse the Europe 2020 strategy as making sense in particular to focus on education, research and employment. But implementing this agenda requires a significant stepping up of efforts as progress is very uneven within the European Union. Using the scoreboard data they construct a scoreboard based on the methodology of the IMF (2010) that assesses the various structural indicators in 2005 and most recent data for 2010/2011. They relate to certain aspects of growth that could be improved with structural reforms (see page 238 of “Transatlantic Economic Challenges in an Era of growing Multipolarity”, Peterson Institute for International Economics and Bruegel . The North Group (Denmark, Finland, Ireland, Sweden and the UK is not unsurprisingly (their judgment) much further ahead than the West (Austria, Belgium, France, Germany and the Netherlands) and especially the South Group (Greece, Italy, Portugal and Spain), which is severely lagging on all criteria. It may be helpful to strongly foster more reform efforts by any countries being subject to a Macroeconomic Imbalance Procedure.

There is a serious role that the Committee must play. President Barroso said that after the last Council meeting that all the governments discuss Europe 2020 but this level of debate was not continued at national level. He emphasised that there must be ownership of all the 2020 reforms at national level not only by the national parliaments but also by social partners and the regions and in this context full use will be made of all the tools offered by the European Union’s new economic governance.
The Europe 2020 Committee knows from its very good relations with the Commission 2020 secretariat that they do want the EESC to engage with the Europe 2020 process at national level and would greatly value the feedback and perceptions we can offer through such contacts.

**Political Union**

If the European Union is to successfully carry out the ambitious medium-term institutional changes to financial, fiscal and growth policies policy which will entail some aspects of pooling of sovereignty, giving more power to some European institutions, then some movement towards political union must take place. It has been mentioned that an element in the crisis is the executive deficit, preventing decision making, which partly stems from the lack of democratic accountability.

The lack of proactive decision making for half a decade is striking. While the common depiction is of a crisis in the euro area periphery, it can equally be described as a failure of the euro area centre, i.e. the mechanisms and actors that determine executive policy for the entire euro area (Véron, 2012). Prominent in these are the European commission, the European Council of EU member states’ heads of state, finance ministers, Eurogroup and others. European institutions have been long criticised for the democratic deficit and the crisis has revealed a similar executive deficit. The lack of democratic legitimacy is contributing to the paralysis of executive decision making.

Véron points to a number of democratic deficiencies in European decision making. First, EU citizens lack equal representation in the European Parliament, a shortcoming cited in June 2009 by Germany’s federal constitutional court as the reason for Berlin not to surrender national fiscal powers to Brussels. In addition the European Parliament lacks control over financial and other executive decisions. Second, the European Council does not have a framework to ensure collective accountability. Its heads of state are exclusively accountable to their respective national citizens, but the Council as a whole is accountable to no one. Third, when electorates were consulted on successive treaty revisions negative responses have not been answered by a change of orientation (the French and Dutch rejection of the constitutional treaty).

Véron recognises the advocacy of more democratic accountability as a means to reinforcing Europe’s ability to make executive decisions but poses the possibility that if a proper European executive decision-making and oversight process had existed in banking, fiscal and structural policy areas during the past decade, the systemic banking fragility could have been resolved as early as 2009, a special resolution regime for all European banks could have been introduced early in the crisis, instead of discussions only starting in June 2012 and Greece’s sovereign debt could have been contained in early 2010.

Profound changes must be made in Europe’s institutional framework to make it effective in this crisis and in prevention of future crises. An authoritative European executive-level framework must oversee banking, fiscal and structural policies. This framework must be accountable to European citizens and for this, in Véron’s view, the European Parliament must become more representative and exert better
control over policy making. This will take several years but should not prevent essential emergency short-term issues from being taken to end the crisis.
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