

Visions for Economic Policy Coordination in Europe



IMPRESSUM

Herausgeber und Medieninhaber/Published by:
Bundesministerium für Wirtschaft, Familie und Jugend (BMWFJ) -
Federal Ministry of Economy, Family and Youth
Stubenring 1
1010 Wien

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Redaktion/Editorial team: Abteilung C1/1, BMWFJ/

Layout: josefundmaria. Die Werbeagentur, Weinholdstraße 20a, 8010 Graz
Druck/Print: Outdoor Production, Getreidemarkt 10, 1010 Wien

Vienna, June 2013

Die in dieser Publikation enthaltenen Beiträge und Aussagen stellen die Meinungen der Autoren dar, nicht aber zugleich die Position des BMWFJ.

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Preface

Federal Minister Reinhold Mitterlehner

The economic and financial crisis that in 2008 originated in the U.S., crossed over to the EU, and eventually impacted the whole world, revealed structural weaknesses of the EU and the Economic and Monetary Union. The serious economic problems affecting several Member States are due to heterogenous causes, like excessive sovereign debt and deficits, an instable banking sector, or current account imbalances. The EU has recognized the seriousness and reasons of these problems and acted fast to overcome them. First and foremost, with its rescue package, which evolved from the first bilateral assistance programmes to a full institution, it has succeeded to secure the stability of the Monetary Union. But the European Union has improved its regulation not only in the area of fiscal or other macroeconomic imbalances. Moreover, important steps toward the realisation of a European Banking Union are to be taken at this juncture. The swift and decisive action at the EU level has renewed and strengthened the credibility of the EU and the trust in its ability to solve upcoming problems.

Although the EU is highly competitive and continuously improves its goods and services, the quality of the work force as well as of its political processes and regulations, the competitors are not idle. Not only the U.S., but also the BRIC countries are serious competitors in contest for headquarters. The EU must therefore develop further in order to be able to succeed in a competitive international environment in the short as well as in the long run. But the EU has not yet taken a clear-cut decision about its long term perspective - say for the next 20 or 30 years. Should and will the EU follow the example of the United States and become a federal State? Will some Member States quit the Eurozone leaving behind a „hard core Europe“ regrouping stable national economies? Or will the integration process come to an end after the creation of the Banking Union?

Within and in addition to these scenarios there is a broad range of further options. It is safe to say that today the EU is at a crossroads. But before the EU heads off into one or the other direction, the different alternative choices should be discussed widely and the pros and cons evaluated thoroughly. This

brochure is supposed to provide a useful input into this discussion. Its contributors cover a wide range of possibilities for the further development of the Monetary Union. I want to thank all authors for their reflections.

Undoubtedly, Austria is one of the countries which until now has profited most from the European integration. In each step, be it the Single Market, the common currency or the enlargement, it was one of the greatest winners: Broadly speaking, Austria has benefited three times as much from EU enlargement as the EU-15. As a direct effect of integration, according to a study by WIFO, Austria has achieved to increase its growth all together by 0.5 up to 1 percentage points per year. So it is safe to assume that future integration steps will again be beneficial for Austria. This is why I am convinced that it is in the interest of the Austrian economy, its enterprises and citizens to continue to opt for a policy of "more Europe".

Why does Europe need more Economic Policy Coordination?

Michael Losch

Throughout the history of European integration, there has been a discussion about the right level of coordination and harmonisation and the creation of centralised institutions. So far, this evolution was a one-way street towards an ever closer Union. Internal market, competition law, customs union and trade policy have formed the core of economic policy from the beginning on. With the Maastricht Treaty of 1992 the common currency, the Euro, has marked the most significant step of economic integration, creating a unification perspective going far beyond pure economics. However, since the aftermath of the 2008 financial crisis, the smaller choice in policy instruments at national level to respond to macro and microeconomic problems has also become a major challenge for a new overall economic policy coordination.

The introduction of the subsidiarity principle in the Maastricht Treaty and the questions concerning a clearer distinction of competence between Member States and the Union put forward by the Laeken Declaration of the European Council in December 2001 have led to the current Treaty of Lisbon. It was signed in December 2007, thus prior to the economic disruption caused by the financial chaos in 2008.

Consequently, without detailed crisis management guidance from the Treaty, a lot of measures have been decided and implemented since then. They relate to the Stability Mechanism ESM which attenuated the strict „no bail-out clause“, a new set of financial market regulation - still work in progress - and an overarching economic policy coordination attempt called the „European Semester“. Before entering into the discussion of how to move forward with policy coordination, a short glimpse on the economic reality of overall EU economic performance and disparities among EU - with particular focus on selected Eurozone members appears useful in order to demonstrate that there is a case for improvement.

Figure 1: GDP development Austria, EU, US

Source: OECD, May 2013



The 2008 global financial crisis has imposed a similar reaction pattern to the EU and the US until 2011. However, since 2012 it has become evident that Europe has more difficulties in coming back to a sustainable growth path than the US. In addition to the already expected and acknowledged fact that the relative position of Europe compared to the emerging countries - in particular the BRICs - is worsening, a widening gap to the US can be observed.

What are the reasons for the increasing gap between growth in Europe and growth in the US? Are macroeconomic disparities and tensions within the Eurozone the problem or are structural policy and competitiveness issues the right explanation?

A Comeback of Industrial Policy

Discussions on EU level seem to suggest, that there are primarily structural and micro economic policy reasons for the poor economic development since 2012, rather than differences in macro and monetary policy. Hence, the European Commission, following the suggestions of Vice President Tajani, put the challenge of de-industrialisation into the focus. The target of a 20% industry share in GDP has been put forward against the background of a decreasing share of industry to a current level of 15%.

European industry is indeed challenged by some growing structural comparative disadvantages. They go beyond the traditional story of high labour costs - partly offset by higher productivity through skills and innovation, and partly taken into account in various off-shoring and outsourcing moves, benefitting a high income population with cheap import products. With the recent gravity shift to the BRIC states, new structural risks appeared relating to the availability and cost of raw materials and in particular to energy prices. At the same time, there is an unachieved global level playing field with respect to the costs of CO₂ emissions since our global partners, BRICs and US, failed to introduce equivalent emission trading systems so far. This increases the risk of delocation, deindustrialisation of the EU and, moreover, of carbon leakage - meaning that the overall CO₂ emissions might even rise due to lesser emission standards in those countries.

The importance of a strong industrial base for long term job and growth stability has several aspects, going far beyond the immediate number of jobs lost after a closure or delocation: First, and most simply, all goods that Europe has to import instead of producing them at home with own value added, need to be paid for with other revenues e.g. from services exports. Secondly, it is more and more realized that the successful development of many services, e.g. technical or design services, builds on a strong link to industrial production. If industrial production is lost, there is thus also a risk for connected services. And thirdly, also research and innovation is strongly linked to industrial production. Evidently, Chinese policy aims at complementing its industry base with bold R&D investments.

Microeconomic analysis not only explains overall challenges to EU competitiveness but can also contribute to a deeper understanding of disparities between Member States. A look at the development over time of the current account balance shows that disparities reached a maximum in 2007, just before the collapse of the financial system. These disparities were already a signal for diverging structural economic developments relating to the competitiveness of the local industries. Countries with a strong negative current account balance were more and more balancing their loss of industry competitiveness with credit and asset bubbles. Thus, one could argue that the structural microeconomic problems constituted the cause of the 2008 crisis, and the financial markets - sparking over the Atlantic - were just the trigger. Indeed, countries with a competitive industry sector and a positive trade balance showed more resilience against the financial crises so far. However, as a second round effect, their exports to countries with shrinking demand, started to suffer as well.

Figure 2: Current account balance

Source: OECD, May 2013

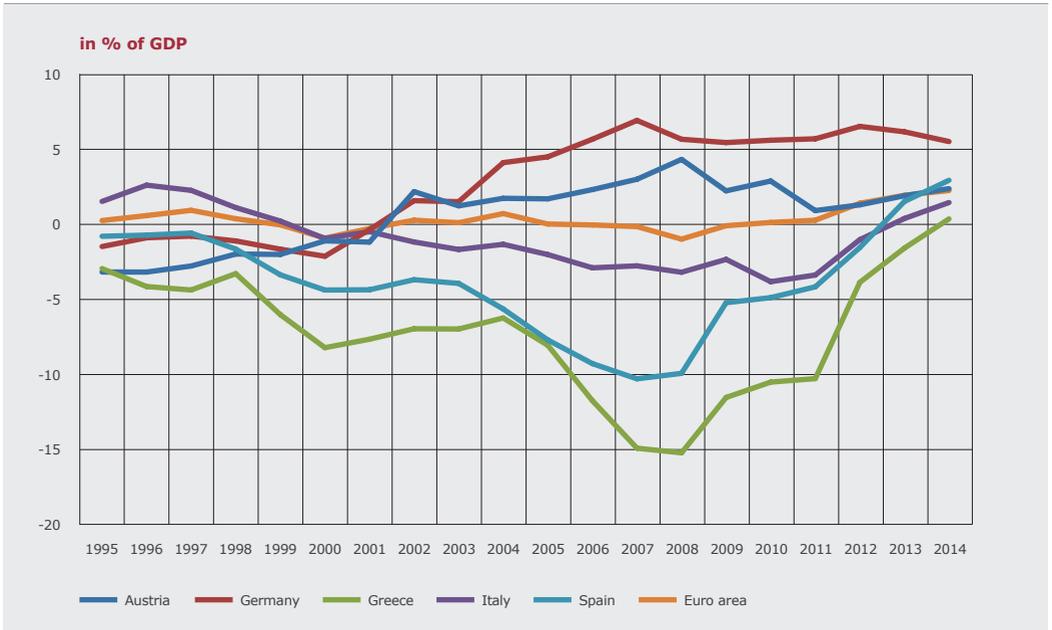


Figure 2 could prima facie suggest that there might be a direct trade-off within the EU between Member States with a positive and Member States with a negative current account balance, thus balancing each other out. This led to the discussion in 2010 about a possible negative effect of especially the German surplus, quasi forcing other countries into deficit. The more complex reality is, however, that trade with third countries has to be taken into account. Thus, any loss of trade surplus in Germany or Austria would not necessarily result in a corresponding increase of the balance of a specific deficit country but rather to an overall deterioration of the EU balance towards the rest of the world. Finally, the positive development of the current account balance in more recent years in Greece and Spain are indeed seen as a first sign that structural reforms yield more competitiveness.¹

Structural problems leveraged with low interest rates

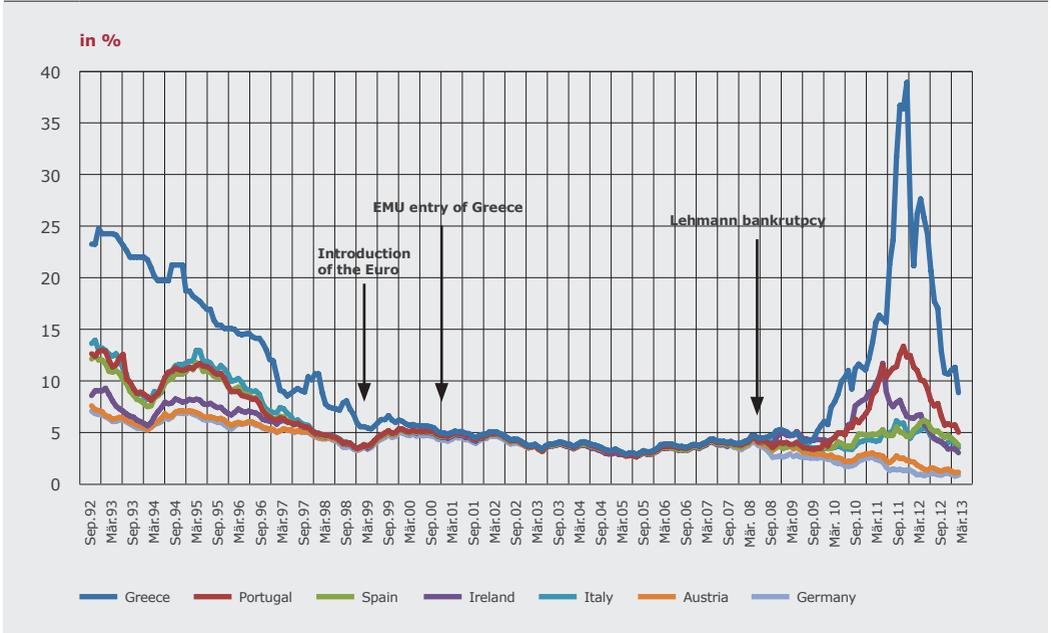
From the start of the Euro until the “Lehman-event” in 2008, microeconomic disparities were ignored by financial markets. Figure 3 shows the development of long term government bond yields, and how the introduction of the Euro as the common currency led to a significant decrease in interest rates in particular for Greece, but also for many other Eurozone Member States. Between 2000 and 2008 we saw a nearly 100% convergence and zero spread of interest rates at a very low level, despite the significantly different positions of Member States with regard to current account (competitiveness) and budgetary balance (fiscal stability).

The low interest rates fuelled excessive investments in states and projects with low competitiveness and productivity. Cheap credit rather boosted consumption or real estate prices, finally leading to bubbles.

1 European Commission: Alert Mechanism Report 2012

Figure 3: Long term government bond yields

Source: OeNB, own illustration



As a result, until 2008, investments contributed only little to enhancing productivity, and thus unit labour costs increased every year at rates which were 2%-4% higher than in Germany. Figure 4 also shows that unit labour costs reacted one year earlier in the US and in Spain, compared to Austria and Germany. This is attributed to more flexible labour markets and a high proportion of temporary workers in the case of Spain².

2 Ministerio de Economía y Hacienda: Evaluating the long-term effects of labour reform in Spain, 2011

Figure 4: Development of Unit Labour Costs

Source: OECD, May 2013

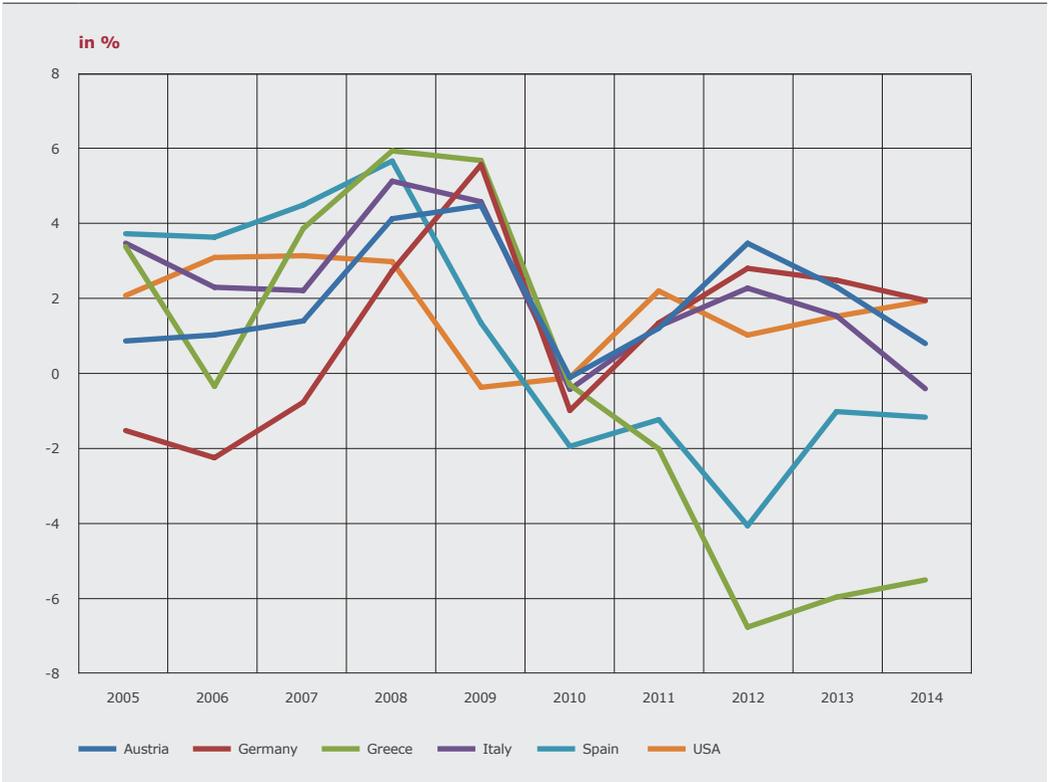
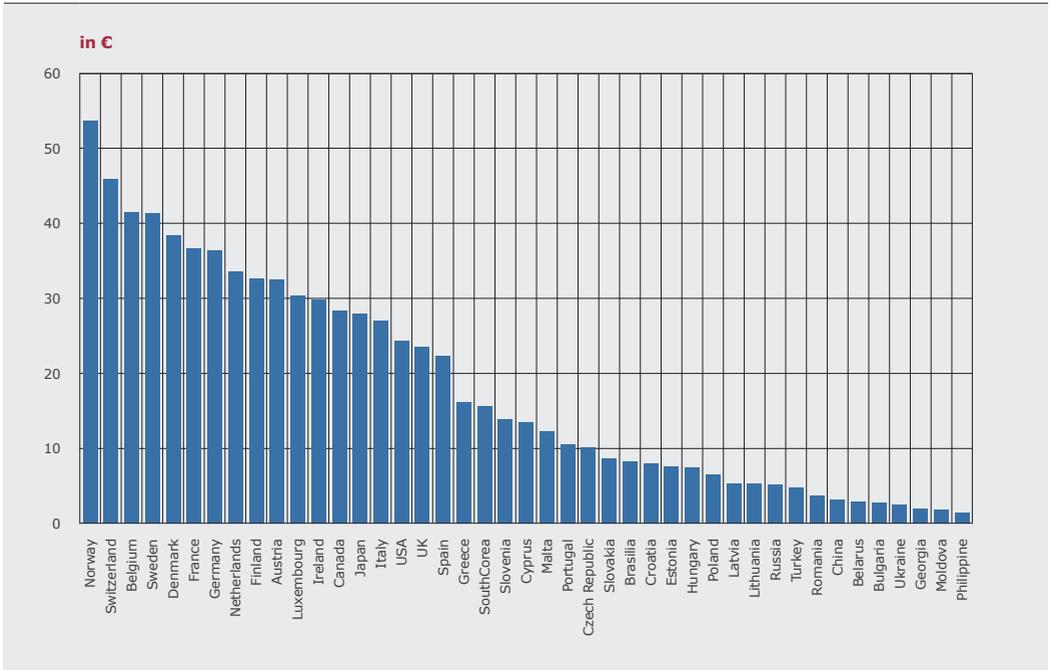


Figure 5 compares in absolute Euro the labour costs per hour worked in the global context. The data shows that differences of labour costs among Member States within the EU are significant, often bigger than e.g. the differences between the EU average and the BRIC countries. Labour costs in Belgium, Sweden and Denmark are ten times higher compared to Romania and Bulgaria. Labour costs in China or in Turkey are already higher compared to the lowest within the EU. This picture thus raises again the issue of priority of convergence and solidarity within the EU versus priority of external competitiveness. The example of some high labour cost countries also shows that overall competitiveness or success of an industry does not solely depend on the labour costs but rather on the combination of labour with capital, skill and innovation raising total productivity.

Figure 5: Labour costs per hour worked 2011

Source: Institut der deutschen Wirtschaft Köln



Abolishing structural diversity and disparity within the Eurozone is not guaranteeing overall improvement. Diversification of country strategies may reduce risk. Competition between different regional innovation systems – as long as fair and within a clear internal market framework – may boost Europe more than a “one size fits all” planning.

On the other hand, the above mentioned industrial policy challenges from the lack of a global level playing field – from raw material protectionism, to social dumping, to environmental carbon leakage – call for a common strategy and unified voice of the EU in the world.

There are no simple answers and there seems to be no political consensus yet either. Thus, there is need for more analysis and economic policy debate. Crucial questions for a differentiated debate remain:

- Is the assumption right that the newly established monetary policy and stability instruments together with the planned banking union will ensure a stable Euro? Can remaining disparities and centrifugal forces be channelled towards structural reform and more global competitiveness?
- What level of macro- and micro-economic policy coordination is optimal for growth and high employment or just necessary in order to guarantee long term stability within the Eurozone? Which policy areas are priorities for stronger coordination?
- What kind of coordination is best and feasible - centralised planning versus decentral-subsidiarity based regulation or competition and market based approaches?
- How can democratic legitimation of important economic policy decisions and the legitimacy and accountability of new instruments and institutions be improved?

The UK's Vision for The EU: a much needed rethink?¹

Phillip Blond

The profound difference between David Cameron's view of Europe and that of other European leaders, looks both deep and unbridgeable. It is of course an expression of deeper conflicts and divisions in Europe. And if the UK/EU dispute can be taken as emblematic of these divisions – its resolution is of deeper importance than just a bilateral quarrel. But there is a double blindness at play in the differing idea of Europe that the EU and the UK offer, where each believes in its own fictions and belittles the critique and vision of the other.

The Euro and Europe

On the EU side there is almost no consideration given to the idea that what might be in the interest of the Eurozone is not in the interest of the European Union. In part this stems from the almost universal insistence on the part of the governing elites in Europe that the Euro must be saved, and a deep irritation that Britain is doing nothing to help. Understanding this Euro resolve requires understanding European history and the visceral fear that all Europeans have of another conflict. In short what Britons cannot understand is that the Euro now stands proxy for European peace and European security.

Yet the opposite analysis that the Euro is the fundamental threat to European security is a sustainable and rational position, especially given the on-going economic crisis. On this account the Euro forces different and divergent economies into one fiscal model under which all cannot prosper. At its most simple Germany's exchange rate is artificially low (roughly 30% less than it should be) while Greece's is wildly elevated. At its most complex there are

1 An earlier version of this article appeared in the journal Social Europe in 2012.
http://www.social-europe.eu/2013/01/cameron-speech-and-britains-new-vision-for-europe/#_ftn1

issues of internal capital imbalances that arise between divergent economies which nobody has yet addressed and nobody seems to know how to tackle. Internal devaluation is oft mooted as the means to reduce costs and restore competitiveness but that involves Germany and similar nations accepting rising wages and a loss of relative competitive advantage. Plus there is a level below which internal devaluation cannot go – no matter how poor people are. Inbuilt costs such as housing and transport tend not to fall as precipitately as wages. All of this means that the Euro is a source of permanent financial disparity and therefore permanent political instability.

While the Euro clearly lowers the transaction costs of trade, perhaps its most notable negative achievement has been the massive flows of capital into unproductive sectors of recipient economies most notably those of housing and pay. From Portugal to Greece, the checking of these flows through limits on debt expansion has seen frightening falls in living standards and destruction of asset values and the savings linked to them. By this reading it is not quite clear what the economic future of the Southern European economies is and when they face over 50% youth unemployment as they do in Spain and rising support for extreme fascist parties in for example Greece (15% for Golden Dawn and rising) – it is uncertain how long social stability can be maintained. Nor is extremism just confined to the southern economies – Geert Wilders continues to poll around 28% in The Netherlands and in France The Front National is becoming a mainstream and embedded political force; Plus all of this is before the final fiscal pact for the Eurozone members is agreed and national financial autonomy is stripped away to be reinstalled at some EU centre where national public expenditure and conditionality are traded off – such as agreeing national budgets in return for reducing debt or improving labour market flexibility. This will in effect determine national politics in the weaker debtor nations and since it will rob desperate people of any ability to respond to their own situation one can immediately see insurgent political parties who support leaving the Euro being elected with large mandates.

The Euro originally conceived as a means to ensure political convergence is then now an agent of economic divergence and profound social disorder. Youth unemployment in Spain is at catastrophic levels, and this contagion is spreading throughout Europe. The politics of internal devaluation forces

the Greek economy back 11 years whereas the Portuguese must go back to 1997 – a generational loss of 18 years. Eurozone unemployment is at 11.8% a historic high – but that average disguises worse news – 26% unemployment in Spain and a similar level in Greece, Portugal is up to 16% and Italy will probably reach Spanish levels as soon as the debt issue is finally forced through its political system.² Overall according to Eurostat, unemployment increased in 18 member states in the year up to November 2012, and given how far devaluation is expected to go is set to rise even higher.

The aim of such hard medicine is to restore convergence and internal economic equilibrium to the Eurozone but on many indicators asymmetries are increasing. For example in 2012 Italian GDP was 6% below its 2006 level in Germany GDP is 8% higher – internal devaluation is driving debtors further apart from creditors, in which case the patient will not survive the cure.³ Europe's current elite cannot countenance Euro failure and they cite other positive indices to show that convergence is possible, and countries have made progress. For example the eurozone's aggregate fiscal deficit fell below 2.5% of GDP at the beginning of 2013. It stood around 3.4% last year, down from a terrifying (as it is not yet shared collectively) 4.1% in 2011. But severe imbalances remain and look relatively intractable – Germany's current account surplus is stubbornly high at 6% of GDP. Goldman Sachs has recently calculated on an exchange rate basis the adjustment still needed to provide convergence and its still enormous about 25-30% in the case of Spain and around 15-25% not only in Greece and Portugal and also in France. But the gap is even larger as surplus countries need to appreciate. Germany on these figures requires for example a real appreciation of 15-25%.⁴ So on some measures the gap remains as high as 50% in exchange rate terms – given the cost so far this represents a genuinely terrifying prospect.

Basically this means certain countries may not politically survive the transition and facing generational unemployment may well elect parties and politicians who promise to exit the current regime. Medium term Euro break up is

2 http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Unemployment_statistics

3 http://www.voxeu.org/article/eurozone-crisis-it-ain-t-over-yet#.UP_SmHm7uGc.twitter

4 <http://www.reuters.com/article/2013/01/22/us-eurozone-economy-rebalancing-idUSBRE90L09B20130122>

still possible not least because northern voters have yet to see the true costs of the status quo: semi-permanent subsidies of a new order of magnitude to southern debtor nations. Most voters in Europe's creditor nations believe that the debt problem is one of overhanging stock – a situation that might be resolved by a one-off pooling of existing debt. But the problem is far worse than that, the situation given the permanent capital imbalances is one of flow – the debt support needed is long term perhaps even generational. As such pressure for Euro break-up will not just come from the citizens of southern debtor countries but from the taxpayers of northern creditor nations outraged that the cost of bailout will pass to not just themselves but their children also. Little wonder then that the latest Eurobarometer surveys show that just 30% of Europeans have a positive view of the EU – hardly a popular foundation for the travails to come.

So it is not self-evident that doubting the Euro is doubting Europe and if the case that the Euro might not be in the interest of all European nations is accepted, then what follows from this is far more amenable to UK interests and perceptions that many Brits and Europeans would believe. But before we address a new structure for the EU and a potential settlement with the UK let us examine the current state of the debate in Britain herself.

The UK and The European Union

For what David Cameron did when he first welded the veto was to preserve the distinction between the EU institutions and those of the Eurozone. Now he may well not have exercised the veto for reasons of institutional distinction and EU integrity but in effect this was what was achieved and I believe this to be both laudable and desirable. If the arguments of the foregoing paragraphs are accepted then there clearly is a rationale for maintaining different ways to be in the EU.

From Britain's perspective, euroscepticism has poisoned British political debate on the right for decades. What the British right most objects to is the perceived and real loss of UK political and parliamentary sovereignty. Recent decisions by the European Court of Human Rights overturning UK terror control and deportation orders have helped to further inflame popular opinion

and create the appearance at least of a populist UK euroscepticism. This coupled with a cross party concern at the Euro crisis and a belief on the left that a simplistic pro-EU stance is no longer politically possible has created a climate for a final in/out referendum on the UK's membership of the EU. A November 2012 poll in the Observer newspaper⁵ showed 56% of Britons would vote to leave the EU in a referendum and that included 68% of Tory voters and 44% of Labour supporters as well.

Cameron's problems with his own party on the EU issue are well known. Issues on Europe have split the party before and could easily do so again. Simply put the EU has been the source of the largest Conservative party rebellion of the current administration and the government is no longer assured of any majority on this issue in the House of Commons. Adding to the pressure on Cameron is that his party is haemorrhaging support on its right flank to the avowedly eurosceptic UKIP. And UKIP are now polling above the in government and pro EU Liberal Democrats nationally. At the last election UKIP cost the Conservatives at least ten seats – possibly more – and this figure could easily double at the 2015 election, costing Cameron his majority and premiership.

Leaving aside party considerations it seems possible that Britain will have an in/out referendum after the next general election. If Labour wins Ed Miliband would want to avoid such a vote, while Cameron would feel obliged to hold one. Even so none of the leadership of the main UK political parties wants the UK to leave; even Cameron favours membership of the EU but with an extension of various opt outs: a maximal autonomy compatible with maintenance of the single market and Britain's ability to access it. A sizable minority of conservative MP's favour exit whilst a majority of all MP's do not but are clearly open to a more populist stance on the EU.

But the assumptions governing the present UK debate are highly questionable. Firstly the purported British majority for EU exit reflects a population that has only heard for years one side of the argument. That it is barely over 50% shows if anything that the majority position is capable of being won by an ef-

5 <http://www.guardian.co.uk/politics/2012/nov/17/eu-referendum-poll>

fective pro-EU campaign, which incidentally has yet to form. And this is before British business has weighed in with dire warnings of the loss of jobs and capital that would follow from a UK vote for EU exit. Plus the United States has a clear interest in the UK being its bridge into Europe and is intensely opposed to Britain leaving the EU and has already made this publically clear. To my mind an in or out referendum would more than likely be won by those who wish to remain inside the EU, leaving British euroscepticism as a defeated minority position utterly bemused by its loss.

After all this is what has always happened when the UK has been offered such a stark choice. Those arguing for an EU exit have always lost whenever it has been put to the national vote. Harold Wilson won the referendum on EU membership in 1975 with a crushing victory for the pro EU position. And when the Labour party in 1983 and 1987 offered in their election manifestos withdrawal from the European Union they were heavily defeated. As all the eurosceptic Tory campaigns since 1997 have been as well. And Cameron got to number 10 by wholly ignoring the Europe issue.

The Wholly Out Option for the UK

For what the eurosceptics struggle with explaining to the British population is quite how they gain from leaving Europe. Yes there is a loss of sovereign autonomy on joining the EU club but this surrendered independence is arguably no longer the asset it once was. Across the world countries are grouping for trade benefits and going it alone seems a 19th rather than a 21st century vision. Enjoying splendid isolation as a trading nation unencumbered by European bureaucracy sounds attractive but it would involve surrendering the very thing that most other nations would want to trade with you for – access to Europe's single market. Tory eurosceptics envisage a Commonwealth option for the UK and the Commonwealth is certainly an advantage, as the *Economist* pointed out (The Economist November 24th 2012 p. 42). While Europe is barely growing the Commonwealth is averaging 7% a year and trade inside the group is 20% cheaper than for those outside but the sum of all Britain's exports to the Commonwealth stood at £54 billion in 2011 less than a quarter of its European trade. But quite why eurosceptics

view this as an either or is difficult to see, it seems obvious that European and Commonwealth trade can augment one another – a Commonwealth and EU trading strategy seems much more likely to succeed.

Plus if you pool sovereignty you also increase it. It is hard to see how a relatively small individual trading nation can strike advantageous trade deals with China or the United States, whereas as a trading block of some 550 million souls you self-evidently can. With a massive economic and demographic shift towards China and India and the global south, the idea of Britain successfully operating alone as a trading nation without the internal and external advantages of EU leverage in trade negotiations seems fanciful. With the EU as the UK's largest trading partner even if the British wholly exit we will still be trading with them and will need some regime for doing so. And even the eurosceptics argue for the maintenance of Britain's access to the single market. To be wholly outside the EU regime under a World Trade Organisation (WTO) only relationship and have the same position as the US or African nations would be deeply damaging to UK trade interests. In summation the wholly out option looks suspect and hardly in the UK's interest.

Britain's In Out Option

To be inside the single market but outside the EU has high costs and less gain. The UK could enter the single market under some European Economic Area arrangement (EEA) like Norway which is subject to all the EU rules without being able to influence them or it could seek a more bespoke bi-lateral series of agreements such as exist with Switzerland but this also has its downsides. For example any goods offered for sale in any of the EU's 27 member-states can be sold in Switzerland but not all Swiss goods can be sold in the EU. Nor do these inside outside options come without financial costs. As David Buchan put it in a recent paper for the Centre for European Reform⁶, the UK under such a regime would presumably be expected to pay on a similar basis to the Norwegians and Swiss: 'Currently, Norway contributes Euros 340m a year

6 http://www.cer.org.uk/sites/default/files/publications/attachments/pdf/2012/buchan_swiss_norway_11oct12-6427.pdf

to the EU. If multiplied by 12 for Britain's much larger population, that rate would imply a contribution for the UK of just over €4 billion, or nearly half its current net contribution to the EU budget as a full member.'

Recapitulating the Relationship

Neither Britain nor the EU are in a settled relationships with themselves or each other. Britain has to face down Scottish nationalism in 2014 and then in its own mind it has still yet to settle on a version of its own future. With America's pivot to the Pacific and Europe in crisis, and its Commonwealth relationship never seriously explored, Britain is certain it needs to maintain a global role but is profoundly unsure of how to do so. The danger for the UK is that it remains fatally undecided and trapped in a kind of negative stasis unable to act positively – for it cannot build a future it believes in if it does not know what future it wants.

Likewise with Europe, its leaders are terrified by the demographic dwarfing of the continent that will shortly ensue and are profoundly unsure of its own global role especially when Britain, its most international and globally connected member, is its most recalcitrant. The internal dangers in Europe are blinding people to the emergent dangers in its own near abroad. The Arab spring has left a legacy that looks unlikely to turn to summer since it could well seed fractured states and fundamentalist cantons along Europe's southern border.

Likewise in the East, Russia wholly reliant for its political stability on an oil price of around \$120 a barrel is facing, with the shale gas revolution and new oil finds, the probability of a halving of that price in the next five years. The political consequences of an unstable Russia with Ukraine in play and Belarus so frozen in time it's likely to shatter and profoundly dangerous. And Britain with its military reach and power projection is the only military power in Europe that in concert with others, most likely the French and the Poles, can really defend the continent. Europe needs Britain with its military, diplomatic links and innovation to truly become a force in the world and a place that can defend itself. And of course the more that Britain as the sixth largest trading nation on earth distances itself from Europe the lesser Europe truly is. And Britain as a genuine force for change is probably the only major nation that can lead the genuine

bottom up reform that the EU so desperately needs. Europe needs Britain.

But does Britain need Europe? Economically that is in a simplistic sense self-evident. The effect of EU membership can be seen in the trade statistics. Britain joined the then EEC in 1973, since when its trade with the other member states has grown at an annual rate of 3.3% (after adjusting for inflation). Its trade with countries outside the EU has, by contrast, grown at an annual rate of only 1.3%. Now the argument might be that we have neglected our trade with the rest of the world as a result of EU membership but that indicates a sort of state centralised direction that has been absent from British economic policy and reality almost ever since we joined. Doubtless we should concentrate on the emerging and growing markets but that couldn't mean abandoning our current position. That would be a form of economic suicide. The EU accounts for 48% of total UK goods and services exports. This breaks down as 53.5% of UK goods exports and 39.7% of services. And in terms of services, which are really the future for the UK, Europe is the UK's greatest customer (£68bn out of a £171bn total) well ahead of the USA in second with 20%.

But the EU is more than just a customs union. It represents a political decision and a geo-political opportunity. What Britain's eurosceptics perhaps don't realise is that by 2050 (if Turkey doesn't join the EU) the UK may well be the largest member of the European Union by population and as a consequence the country with potentially the greatest political weight. Given that so many of the new accession countries are excluded by and are hostile to an exclusive Franco-German centre, and positive about the traditions and beliefs of the UK, Britain could really lead in Europe and that coupled with all its other advantages and international connections would make the United Kingdom first among equals as Europe's pre-eminent power. That possibility far more capable of realisation than any other putative vision of global influence is worth something and should not be given up lightly.

The New Future?

So each needs the other but how to facilitate this and make it happen? In short Europe and Britain must find an accommodation. But Britain is not the

only country that Europe must seek to broker a new settlement with. There are many. Nobody is happy with the current arrangements for Switzerland, Norway or Turkey, the EU is utterly confused as to how to approach Ukraine or Belarus. Plus given the internal troubles it is also clear nobody will be in a rush to join the Euro any time soon and even though leaders may not want to countenance it, the current currency union may break up, or centralise around a far smaller number of states. So it cannot be the case that one has to accept the Euro or leave the EU.

After all, the Euro is currently only shared by 17 of the 27 EU nations and agreements already recognise there are members who may never join. Both Britain and Denmark for example have permanent opt outs from the Euro and others can wait and join when their economies are sufficiently aligned. And as mentioned above this wait could be a long time. Poland would probably not like to rush in until the present crisis is resolved, Sweden has a permanent Euro derogation and Bulgaria, the Czech Republic, Hungary and Lithuania do not currently even have a target date for adoption of the Euro. Plus if one considers that the Greeks may exit, it will be necessary to have an institutional space where countries can leave the Euro and yet still remain in the EU. So it is in the clear interests of the EU to create a structure that does not create an exclusive Euro core that in effect subverts the institutions of the European Union. A multi-tier Europe that escapes from the language of inner and outer circles and that is flexible enough to cope with the various needs of those who will never join the Euro, those who may wish to wait and those who may need to leave would be a genuine advance.

Hence the current British wish to renegotiate its relationship with the EU need not be a purely negative engagement. Thought through properly and in relationship with other counties Britain could be a popular force for the reform of the EU. Creating a much more flexible and plural union that better serves the interests of its members. The language of localism and the decentralisation of current powers has already been heard in Europe from the Czechs and opposition parties in the European nations themselves. And localism and decentralisation represents the best of modern British Conservatism. Such a movement for a bottom up reform of the EU could create a quite unexpected mutuality between the UK and other member states. Localisation of various supra-national bud-

gets like agriculture could free the union from subsidising local vested interests and create a truly innovative framework for a 21st century European future.

Given the travails to come, it would be wise for the current set of European leaders who are so strongly committed to saving the Euro to build alongside that project other forms of EU association that maintain and create a place for countries like Britain to be full and participatory members of the European Union. This would draw the sting from British euroscepticism and create a future pathway that both the EU and the UK could build on. That also would free Britain from its position of constantly threatening to deploy its veto to block its own exclusion. Europe is greater than the Eurozone and is always likely to be so – so create a new politics that recognises this and fosters another form of membership and that is flexible enough not to force countries to break with the EU. Institutions survive and prosper by creating spaces for difference and distinction. Abandon the notions of inner and outer and talk instead of what is appropriate to and proper for the needs of members. Angela Merkel is already thinking and acting like this – her statesmanship was notable in her generosity to Britain in interventions earlier this year and was widely and warmly welcomed in the UK. More of this would go far indeed and Europe would be better for it. Create a place where Britain can remain and Britain will not leave. Europeans moreover might well be surprised at the number of countries that subsequently wish to join the United Kingdom, as the Euro crisis will continue to depress Economic growth and drive a deeper wedge into European unity.

Towards United States of Europe

Fritz Breuss

1. Introduction

The global financial and economic crisis (GFC 2008/09) triggered off by housing cum banking crises in the United States spilled over to nearly all industrialized countries and culminated in a "Great Recession" in 2009. This shock hit the European economies, in particular the weaker ones of the Eurozone considerably. Since 2010 one speaks airily of a "Euro crisis", although it is not a "crisis of the Euro". The so-called "Euro crisis" is an amalgam of different – at least three – (but interdependent) causes: a sovereign debt crisis (in Greece, Portugal and Italy), a banking crisis (Ireland and Spain) and underlying a step-up of macroeconomic disequilibria (resulting in current account imbalances because of weak competitiveness in the periphery countries compared to that in the core Eurozone countries) since the inception of the Economic and Monetary Union (EMU) in 1999.

Since the outbreak of the "Euro crisis" Europe is not only economically split but the trust in the EU fell substantially. The economic crisis caused collateral political damages. On the one hand the "multiplicity of Europe" has increased (Euro member states versus non-member states; within the Eurozone countries of the periphery in the South versus those in the core or in the North). Furthermore, the growing need to rescue the periphery countries has alienated the population from the EU. Best examples are the separation ambitions in Great Britain, the mushroom of new anti-EU and anti-Euro parties (e.g. in Germany the "Alternative für Deutschland" – AfD).

In this essay we undertake a look into the possible future of Europe, the EU and in particular in the Eurozone and the chances of the Euro in the years 2030 to 2050. We start with a short description of the status quo of crisis management in Europe (chapter 2). Then in chapter 3 we develop the futures of Europe ac-

ording to the more or less "official" plans so far. The essay concludes with a far view into the future, when Europe is ready to embark into the project "United States of Europe", an old dream of lovers of an ever deeper integration of Europe. Despite occasional setbacks, the history of the European integration since World War II has a clear upward trend. The European Union (EU) deepened its economic integration (from a Customs Union to the Single Market and EMU) and enlarged its size in five steps from six to 28 Member States.

2. Euro's rebirth after the crisis?

With a decline of real GDP by 4.5% the EU and the Eurozone have been more affected by the severe "Great Recession" of 2009 than the United States (-3%). The US could also overcome the crisis much quicker and better than Europe. Whereas the US since 2010 exhibited an upswing with annual average growth rates of real GDP of around 2% the EU and the Eurozone fell back into a second (although weaker) recession in 2012 and 2013 with shrinking real GDP by 0.5% in both years in the Euro area and by 0.25% in the EU. This divergent development is all the more astonishing than the GFC 2008/09 had actually originated in the United States. Apparently, the shock absorbing capacities are much weaker and the reform will be less pronounced in Europe than in the US. Or to put it differently: The United States of America have better crisis tools (centralized fiscal policy with a mechanism of fiscal federalism; a flexible reacting monetary policy by the Fed; quicker reforms of the banking sector and a strict no-bail out regime in the relationship between central government and the federal states) and the US dispose already of a genuine Economic and Monetary Union within a single state and hence, already comply with the common monetary principle "one country, one money". The comparison of the very young EMU of the EU with the monetary union of the USA is unfair, because after all also the US needed more than 100 years to complete it. In 1789, the U.S. Dollar has been introduced with the Constitution of the United States. In the early 1790s, the first U.S. finance minister Hamilton ("Hamilton moment") transferred the sovereign debts of the federal states into debts of the central state. In 1841 a strict No-Bail out clause (the central state does not guarantee debts by the federal states) has been introduced. In 1865 the national banking system was harmonized. In 1913 the

Federal Reserve (Fed) was established. In 1933 a national Deposit Guarantee Scheme (FDIC) was introduced.

In contrast, the EU (being not yet a single state but a union of sovereign states – “Staatenverbund”) and the relatively young Eurozone are far from obeying the monetary basic principle that one money only belongs to one country. Instead, the EMU is adhering to the virtual construct of “one market, one money”. That means the policy design of EMU is constructed as such that one hopes that EU’s Single Market should function with one money (Euro) without disposing of the policy instruments and the power of enforcement which normally are only available in a single state.

The Euro crisis, hence has revealed painfully these weaknesses of EMU’s policy design. Only after the outbreak of the Greek crisis early in 2010 the EU/Eurozone developed step by step a new institutional setup which should make the EMU more crises-proof. Insofar, Europe undergoes a Schumpeterian process of “creative destruction” by overhauling old structures and implementing new institutions to make EMU better functioning in case of future crises. It could well be that we are witness of a rebirth of the EU and the Euro after the crisis. This happens only if the painful cost of adjustment (in terms of increasing unemployment) in some of the crisis-ridden countries of the Eurozone turns soon into a more prosperous development with the hope of a better life. Otherwise the democratic consent and therefore the future of the EU and the Eurozone are at stake.

2.1 New EMU economic governance

Since 2010 the EU by EU law (community method) and partly only the Euro area member states (intergovernmental) have developed new instruments for a “new economic governance” of EMU, grouped into measures in the context of the (A) “European Semester” and (B) “Rescue (bail-out) measures” and “Supervision of the Financial Market”. The whole range of measures could lead to partial “Unions” and lastly to an ever closer Union (see Breuss, 2013A).

A. European Semester

The following old and new procedures of the new economic governance are evaluated and monitored each year within the procedure of the “European Semester” which started in the 1st half of 2011.

A1. "Fiscal Union"

Two legal and institutional tracks could lead to a more centralized fiscal policy:

1. The "Sixpack" with a reform of the Stability and Growth Pact (SGP; stricter rules of budget discipline) and (new) procedures to monitor macroeconomic imbalances. Additionally, the "Twopack" has been added in order to provide a better direct control and stronger surveillance of national budgetary policy in reform countries.
2. "Fiscal Pact": This more intergovernmental pact (only 26 EU member states take part) is an amendment of the reformed "SGP" with limits of budget balances (0.5% of structural balance) and a "debt brake". Additionally, one could mention the intergovernmental agreed upon "Euro Plus Pact" with elements of budgetary surveillance and those of competitiveness. As a complement to the Fiscal Pact, chancellor Angela Merkel pleads for a "Pact for Competitiveness" to help countries with structural reforms to catch-up in competitiveness.

A2. "Single Market Plus"

In 2013 the EU celebrates its basic achievement, "20 years Single Market". In order to make the Single Market work even better, it is amended by the growth strategy "Europe 2020" and the Single Market Act which identifies what elements are still open to make the Single Market really complete.

B. Bail-out measures and the surveillance of financial markets

The Euro crisis forced the responsible politicians of the EU/Eurozone member states to react quickly with instruments which were taboo until then. The challenge of the crisis opened the way towards two "Unions":

B1. "Transfer Union"

At the outbreak of the Euro crisis, starting with Greece in May 2010. there were no rescue instruments available, because of the "No-bail out" rule of Article 125 of TFEU. The choice of a bankruptcy of Greece or bail-out led to the innovation of new rescue instruments. Firstly, Greece was supported to overcome its debt crisis with bilateral credits of the partner Eurozone member states, then a provisional rescue umbrella, the EFSF (European Financial Stability Facility) was installed. Lastly the permanent rescue instrument,

ESM (European Stability Mechanism) was implemented by changing EU law (amendment of Article 136(3)). ESM was classified by the European Court of Justice as being no breach of EU law (Article 125) because – for the time being (if there is no haircut of public debt) – the rescue operations are only credit operations. Anyhow, with these rescue operations (covering now already five Eurozone member states – Greece, Ireland, Portugal, Spain and Cyprus - the EU/Eurozone have embarked in a kind of transfer union.

B2. “European Banking Union”

As a reaction to the crisis, which was to a large extent also due to a crisis in the financial sector, in 2011 the European System of Financial Supervisors (ESFS) started with a new institution (the ESRB – European Systemic Risk Board at the European Central Bank - ECB) and three new agencies: a) EBA (European Banking Authority) in London; b) EIOPA (European Insurance and Occupational Pension Authority) in Frankfurt; c) ESMA (European Securities and Markets Authority) in Paris.

It turned out that these supervisory agencies were not enough to cure the banking crisis. Therefore the new project is the creation of a genuine “European Banking Union”.

Considering the already implemented new measures and instruments of the “new economic governance” of EMU the partial “Unions” (Monetary Union since 1999; Fiscal Union, Single Market Plus, Transfer Union and Banking Union) could pave the way towards an “Economic Union”. Then the EMU would finally consist of all ingredients – with a Monetary Union (M), which it was since the inception of EMU in 1999 and an Economic Union (E) which it will become only after the repairs of the political design fostered by the Euro crisis.

2.2 The new active role of the ECB

Besides conducting the standard monetary policy for the Euro area, since the outbreak of the Euro crisis the ECB embarked more and more and rather quickly into a non-standard monetary policy. Due to the legal constraint of Article 123 TFEU, however, the ECB cannot play the role as a “Lender of Last Resort” (LLR) for Member States of the Euro area. Unlike the Fed in the USA and the Bank of

Japan, it can only play the role as “LLR for banks” or indirectly also for Member States insofar it buys sovereign bonds at the secondary market (ECB as the “Market Maker of Last Resort”) it can exert pressure on the overly high spreads of the countries in crisis of the Euro area periphery since 2010.

ECB President Mario Draghi made a very important statement in his speech at the Global Investment Conference in London, 26 July 2012. More or less off the record he “dropped a bombshell”: *“Within our mandate, the ECB is ready to do whatever it takes to preserve the euro”*. “And believe me, it will be enough”. This was a strong signal to the financial markets to stop breaking up the Eurozone and to reduce speculations against periphery countries. This statement followed the announcement of the program of Outright Monetary Transactions (OMT). Both actions were able to stabilize the upward trend in the spreads of sovereign bonds of the periphery countries. The interest rates of their bonds declined considerably since autumn 2012.

The Draghi statement as well as those of President Barroso (November 2011) and Chancellor Angela Merkel (August 2012) to do whatever they can to keep the Euro area in its present dimension of 17 Member States, helped to reduce the probability of a breaking-up of the Eurozone, which were considerably high in the first half of 2012.

2.3 The European Banking Union

Given the fact that the Euro crisis is the outcome of a multitude of causes it is difficult to manage it with only one instrument. Each cause needs a respective answer. Commission’s president Barroso in his “State of the Union 2012 Address” to the European Parliament on 12 September 2012 summarized the causes of the Euro crisis in a nutshell: at its roots, the Euro crisis is the result of three (partly overlapping and reinforcing) causes:

- Irresponsible practises in the financial sector, triggering off a “Banking Crisis”
- Unsustainable public debt, resulting in a “Sovereign Debt Crisis”, and also;
- A lack of competitiveness in some Member States, causing “Macroeconomic Imbalances” and a “Balance of Payments (BoP) Crisis”.

The “Sovereign Debt Crisis” and the problem of “Macroeconomic Imbalances”

in the EU/Euro area are addressed with the already implemented legal instruments of the "New Economic Governance" describe above.

Before the outbreak of the GFC 2008/09 there was a global tendency to liberalize and deregulate the financial markets (in particular the banking sector) as much as possible. After the crisis a reversal takes place: from regulation to re-regulation of the financial sector. Shortly after the Lehman Brothers collapse the G-20 at its Washington meeting on 15 November 2008 already identified the major problem areas which caused the GFC:

- The "Too Big to Fail" problem, forcing the states to play the role of a "lender of last resorts (LLR) with enormous consequences for tax payers and public debts.
- The "Universal Banking" problem or the request to return to the "Glass-Steagall (G-S) Act" (with the separation of investment from normal banking business) as of 1933; under President Bill Clinton the G-S Act has been repealed by the Gramm-Leach-Bliley Act as of 1999. Since the GFC 2008/09 several proposals have been made to reintroduce a kind of G-S, called the "son of Glass-Steagall": in the United States with the Volcker rule (transposed into law by the Dood-Frank Act in 2010); in the UK suggested in the report by the Vickers commission of 2013; in the EU in the Liikanen report of 2012 which also touches the "too big to fail" problem.
- Return to stricter "regulation" and "supervision" of the financial sector; this task is undertaken in an aggravation of the rules concerning capital requirements and liquidity of banks with the Basel III regulation. The latter is already implemented into EU law with a Bank regulation package, consisting of a Capital Requirements Regulation (CRR), and the 4th edition of the Capital Requirements Directive (CRD-IV). These rules will apply from 1 January 2014.

Within the context of EU's Single Market project, the establishment of a true "European Banking Union" (EBU) aims at solving the third cause of the current Euro crisis, the "Banking crisis". EBU is planned to be completed in three steps:

1. Single Supervisory Mechanism (SSM);
2. Single Resolution Mechanism (SRM).
3. Single Deposit Guarantee Mechanism (SDM)

The rationale behind the EBU project (according to the "Roadmap towards a Banking Union" by the European Commission as of 12 September 2012) is to *"Breaking the link between banks (bank debt) and sovereigns (sovereign debt) and the vicious circle which has led to over €4.4 trillion of taxpayers money being used to rescue banks in the EU"*.

Whereas the first step, the establishment of the SSM at the European Central Bank (ECB), planned to start on 2014 has already been agreed upon by the Heads of State or Government at the meeting of the European Council in December 2012 the next two steps (SRM and SDM) are legal and political tasks of the medium to long-term. The reason is that some countries (e.g. Germany) claim Treaty change for these steps.

Whereas the EBU with its three steps (SSM, SRM and SDM) would be a crisis management form top-down (stabilization of the financial sector by more centralized re-regulation) in the meantime, the stabilization of the financial sector is done with a mixture of top-down (SSM at EU level) and bottom up via a range of regulations and directives at national level:

- Instead of SRM the EU member states are implementing at national level recovery and resolution of credit institutions (inclusive the Bank's "last will"), financed by a Resolution Fund (ruled in the Directive as of 06/2012). The "Cyprus deal" (March 2013) could serve as a template for EBU (and also for the resolution of banks in the national "last wills"). The Cyprus rescue programme consisted of a "bail-out" by ESM plus IMF (€10 bn) plus "bail-in" by Cyprus government (€23 bn) and participation of bank asset holders above the guaranteed amount of €100.000. One envisages a "cascade of responsibility" in case of a failed bank: (i) stake holders of banks (owners of shares and bonds); (ii) asset holders above €100.000.
- Instead of SDM the EU member states are implementing at national level the deposit protection with new national deposit guarantee schemes (national DGS), ruled in the Directive as of 07/2010. Since December 2010 the EU disposes of a harmonized national guarantee level of savings deposits of €100.000 per depositor and per bank.
- Implementation of Basel-III with the bank recapitalisation package (CRR and CRD-IV) inclusive a regulation to cap "bankers bonuses".

The SSM is only a consistent answer to the crisis and lies in the logic of the continuing process of completing the 20 year old Single Market. At the Euro area summit on June 2012 it was recognised that there is an “imperative” need to “break the vicious circle between banks and sovereigns” that is weakening the finances of Euro area countries, to the point of threatening the very existence of the EMU. The SSM will have no direct economic impact, except that it makes the control and supervision of the Euro area banking sector more objective by centralizing it at ECB level. At present morbid banks can only be recapitalized out of the ESM via Euro area member states, which increases the public debt (this was the case in the 2012 banking rescue operation for Spain). After the inception of the SSM in 2014 the ESM will be able to directly recapitalize banks in Euro area member states and hence will be disconnected from public debt accumulation.

3. Futures of Europe

In a longer perspective Europe had always more than one future. Here we start our speculations about the futures of Europe with the status quo. And hence, again there are several potential paths Europe can tread in the future. European (EU) integration had always two aspects: enlarging and deepening.

Concerning the aspect of the size of the EU, there is no political limit to enlarge the EU. One can easily think of EU-40 in the medium to long run. This, however, would imply that EFTA would vanish. However, the more member states belong to the EU the more complex and lengthy will be the decision making process (e.g. in case of unanimity decisions) under the present institutional and legal framework. This carries the risk that the EU will further disintegrate into several circles, the core of countries which are at the front of deeper integration and the periphery of countries which participate in different levels of integration (Schengen, Euro and other policy areas). Therefore, in the future the EU is faced with the decision, either to act with “more Europes” or with “more Europe”. The latter would imply a compact large centralized EU with all member states at the same level of integration. If this is not possible for political reasons in some countries (e.g. in the United Kingdom) then the EU must restart with new impetus.

3.1 The European Union without limits: EU-40

European integration in the sixties and early seventies was characterized by a parallel action of two competing integration entities, the European Economic Community (EEC) since 1958 and the EFTA since 1960. Europe was divided into two integration blocks. Only after the conclusion of Free Trade Agreements between EFTA states and the EC in 1973 – which lead to a free trade area EC-EFTA since 1977 - and the European Economic Area (EEA) Agreement as of 1994 the the EC-EFTA relations were consolidated. Whereas the size of EFTA reached its peak with ten member states, the EU encompasses 28 members now and there is no end of an EU extension in sight. Parallel to the five EU enlargement waves of the EU (1973 Denmark, Ireland and UK; 1981 Greece; 1986 Portugal and Spain, 1995 Austria, Finland and Sweden; 2004 and 2007) six EFTA member states changed the boot (Denmark and UK in 1973, Portugal in 1986, Austria, Finland and Sweden in 1995). Historically, the biggest enlargement step was the “Eastern European enlargement” in 2004 and 2007, when the EU absorbed ten former communist countries (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia) which had to transform their status from planned to market economies, together with Cyprus and Malta. In July 2013 Croatia, the former member state of the Socialist Federal Republic of Yugoslavia will become the 28th EU member states.

With the big 5th enlargement the EU completed a long process of political rapprochement and economic link (via Europe Agreements) of former communist countries to the western democracies. Historically spoken, the 5th enlargement completed the unification of Europe after World War II. After the break down of communism in Eastern Europe in 1989, the collapse of the former empire USSR and the disintegration of the Socialist Federal Republic of Yugoslavia in 1991 the EU made quickly offers to the new independent states in Eastern Europe to access the EU, given that they fulfil the Copenhagen accession criteria (democracy, market economies etc.). Alone for this political peaceful unification of Europe the EU deserved the Peace Nobel Prize 2012.

Although the enlargement process came to a halt during the Euro crisis, there is no limit to enlarge the EU further. The Treaty (Article 49 TFEU) has a simple rule: *“Any European State which respects the values referred to in Article 2 and is committed to promoting them may apply to become a member of the*

Union.” One of the political priorities of the EU is to stabilize the Western Balkans. That means that the EU will try to absorb – after Slovenia and Croatia – step by step the other succession states of the former Socialist Federal Republic of Yugoslavia. By the accession of the rest of the countries of the Western Balkans (Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia) would enlarge the EU by six countries to the size of EU-34. After taking in also the four remaining EFTA states (Iceland – is already negotiating for EU membership; Liechtenstein, Norway and Switzerland) the EU would grow to EU-38. Then only two European states – the Ukraine and Belarus – would make the Union one of EU-40. As Europe consists of further small states (e.g. Moldavia) the EU could increase even further in size. Of course, this drafted enlargement process is only a theoretical speculation. Except the states of the Western Balkans and some Eastern European countries, not all mentioned potential EU candidate countries (in particular the EFTA states) are willing to enter the EU.

3.2 20 years of the Single Market

After the establishment of the Customs Union in 1968 the next big integration step in the EU was the creation of the Single Market in 1993. Far from being completed, it is the basis of EU integration. In 2013 the Single Market is celebrating its 20st anniversary. The Single Market with its four freedoms (of goods, for services, capital and labour) is the level of integration all member states must adhere. All newcomers have to adopt the *acquis communautaire* of the Single Market. Even very EU sceptical countries, like the UK can accept the status of the Single Market.

When it became apparent that the integration gains forecasted by the Cecchini Report in 1988 (0.75% more real GDP growth per annum) would not materialize, in 2010 the “Lisbon Strategy” was announced. This “growth strategy” should push growth and jobs within a 10 years period with the goal that the EU until 2010 *“to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion”*. Well in 2010 – shortly after the “Great Recession” of 2009 – it became clear that these objectives could not be achieved.

As a consequence a new 10 years growth strategy were launched, the "Europe 2020". Again new ambitious goals (raise the employment rate; invest 3% of GDP in R&D; reduce greenhouse gas emissions by 20% etc.) are targeted and should be realized by pushing the EU economies to paths of "smart growth" (by innovation, education and a digital society), "sustainable growth" ("Resource efficient Europe" strategy by decoupling economic growth from the use of resources (climate, energy, mobility); improving competitiveness) and "inclusive growth" (by fostering employment and skills and fighting poverty). In view of the negative impact of the management of the Euro crisis (recession and increasing unemployment in the periphery countries of the Euro area) it is not sure whether this new growth strategy will give European growth wings. Additionally, with the "Single Market Act" - a scoreboard of measures to complete the Single Market finally - the European Commission will stimulate growth. But as the example of the lengthy implementation of the Services Directive (agreed upon in 2006, transformed into law in the EU member states only in 2010) demonstrated, it is no easy task to really complete the Single Market programme as announced at the start in 1993.

In Europe we are stunned by a still unresolved "integration puzzle". This consists of the fact that Europe's economy (in particular those of the EU) is growing permanently slower than those of the USA. All ex ante studies on the economic effects of EU integration (e.g. the Cecchini report and many other academic analyses) forecasted an integration bonus of 0.5 to 1 percentage point additional GDP growth per annum due to the deepening of European integration (by the Single Market and by EMU). Instead of this theoretically foreseen integration growth bonus of the EU since 1993 the US economy (without additional integration effects) grew consistently faster than those of the EU. During the period 1993 to 2014, real GDP grew at an average annual rate of 2.5% in the USA and only of 1.6% in EU-27. Without the fast growing new member states (EU-15), the performance was even worse by 0.1 percentage points. Taking real GDP per capita the growth gap EU-USA is only around 0.2 percentage points. Nevertheless, experiencing an extreme high dynamic of economic integration since the inception of the Single Market the EU (in particular the enlarged EU) should have been able to perform much better than countries without these huge integration impulses. The "integration puzzle" could be explained partially by the fact of the split of the EU-28 into a Euro

and a non-Euro group of countries. The possibility of the non-Euro countries to devalue against the Euro could impede the exhaustion of the full growth potential of the Single Market.

3.3 “More Europes” or “more Europe”

The pre-crisis status of the enlarged EU-27 already was characterized by a trend towards “flexible integration” or “Europe à la carte”. Not all (old and new) EU member states took part in all integration steps so far (EMU, Euro, Schengen, Common Foreign and Security Policy, CFSP). This trend of separation of the EU was aggravated during the Euro crisis. Since then we see a strong movement towards “more Europes”. On the other hand, the crisis management clearly points towards “more Europe”. Currently, we see a virtual fight between two movements, centralization versus Europe à la carte.

The movement “more Europes” has got momentum during the Euro crisis. As already mentioned before, the basic element of EU integration is the Single Market. All member states (old and new) must accept the *acquis communautaire* and take therefore part in the Single Market programme. The first separation of economic integration of EU-28 is those between 17 Euro area member states and 11 non-Euro area members. Since the outbreak of the Euro crisis in early 2010 and the necessary crisis management we see a further split within the Euro area between the countries in the North (the core and at the same time the donor countries) and the South (the periphery and the borrower countries under the rescue umbrella). As mentioned before, the new economic governance includes measures to centralize or strengthen cooperation fiscal policy which finally could lead to a “Fiscal Union”. Some of the new instruments are based on EU law (the “Sixpack” and the “Twopack”) applying to all 28 EU member states, some instruments (the “Fiscal Pact”) are only signed by 26 EU member states (the same is true for the “Euro Plus Pact”). So in the end we are creating an incomplete “Fiscal Union” (one for only a subset of the EU member states).

Participants of the new rescue instruments (EFSF and ESM) are only members of the Euro area. The non-Euro countries stay aside. In practise the core countries are donors and the periphery countries are borrowers. Insofar, the “Transfer Union” is also incomplete and does not cover all EU member states

but only those 17 of the Euro area. Although the ESM was legalized by amending Article 136(3) of TFEU it is only an international treaty which members are those of the Euro area. Hence, the Euro crisis management deepened the gap within the EU-28 between countries with the Euro and those without. The new economic governance of EMU is only fully applicable to Euro countries.

A new element of separation will be brought about by the European Banking Union which in a first step only should cover the banks of the member states of the Euro area. The other EU member states are invited to participate. But again in the meantime we will have an incomplete "Banking Union" within the EU-28. The movement "more Europe" with further centralisation of economic policy should lead – as will be elaborated in the next chapters – over an "Economic Union" towards a "Political Union" and as a far-reaching goal possibly towards "United States of Europe" (USE).

3.4 The new EMU à la Barroso and Van Rompuy

On behalf of the European Council (the Heads of States or Government of the EU member states) the President of the European Commission, José Manuel Durão Barroso as of 30 November 2012 and the President of the European Council, Herman Achille Van Rompuy as of 5 December 2012 developed plans for a "genuine EMU" (see Breuss, 2013A).

The "Barroso plan" develops "a blueprint for a deep and genuine EMU" in three steps:

- In the short term all the new instruments and measures already implemented in the new economic governance are listed, inclusive the goals of an EBU. According to the European Commission this can be realized by secondary EU law.
- In the medium term new (politically delicate) measures are mentioned. Proper fiscal capacity (own budget) of the Euro area; redemption fund, Euro bills. The Commission admits that these new instruments can only be implemented by a painful Treaty change. A novel feature is the creation of a "Convergence and Competitiveness Instrument" (CCI) maybe in the context of Merkel's "Pact for Competitiveness".
- In the longer term the European Banking Union (EBU) should be fully com-

pleted and the EU should have converged to a full Fiscal and Economic Union. The "Barroso plan" also contemplates about a "Political Union", given one sees commensurate progress on democratic legitimacy and accountability.

The "Van Rompuy plan" develops also "a roadmap towards a genuine EMU" in three phases:

- Stage 1 should ensure fiscal sustainability and breaking the link between banks and sovereigns by the help of five elements: the implementation of the new economic governance ("Sixpack", Fiscal Pact etc.); the SSM; harmonization of national bank resolution and deposit guarantee schemes; direct bank recapitalisation through the ESM.
- Stage 2 should complete the integrated financial framework and promote sound structural policies with the help of two elements: the completion of the integrated financial framework via setting up the SRM and SDM at EU level; a mechanism of stronger coordination, convergence and enforcement of structural policies (a similar instrument as the CCI in the "Barroso plan") based on arrangements of a contractual nature between Member States and EU institutions (Merkel's "Pact for Competitiveness"). Financial incentives should be linked to contractual commitments to reform structures and improve competitiveness. Maybe the CCIs could be financed out of the next Multi-annual Financial Framework (MFF 2014-2020).
- Stage 3 should improve the resilience of EMU through the creation of a shock-absorption function at the central level. For this purpose a well-defined and limited "fiscal capacity" should improve the absorption of country-specific economic shocks ("shock absorption function" of an own Euro area budget), through an "insurance system" set up at the central level. The idea is similar to the "fiscal federalism" mechanism in the USA and Canada. However, whether in the latter countries this mechanism works automatically via the central budget, the Van Rompuy mechanism is only an instrument which could be applied case by case in countries which were hit most severely by external shocks (like in the current Euro crisis the periphery countries of the Eurozone).

Common to both plans for a new EMU is the call for a strong "democratic legitimacy and accountability". In a first reaction, the Heads of State or Government were quite reluctant to the proposals of both plans for a new EMU.

3.5 The Euro for all ...

At the latest since the outbreak of the Euro crisis it has become crystal-clear to everybody that the Euro area is no optimum currency area (OCA). And the Euro did not lead to a convergence of competitiveness via intensification of intra-Euro area trade as forecast by representatives of the so-called endogenous OCA theory. Rarely, an economic grand experiment has been falsified so drastically as the Euro project. The EU politicians – based on the not very well theoretically founded Maastricht criteria to entry the Euro (of which the fiscal criteria could easily be manipulated like in the case of Greece) – have prevailed against the economic expertise and pushed towards a grand Euro area. Against the hope that the Euro would unify the EU it has rather divided it.

The majority of the economists pleaded for a small Euro area of countries with similar business cycles. More or less such a group consisting of countries of the DM block (Germany, Belgium, Luxembourg, Netherlands, France, Austria and possibly Denmark and Finland) would fulfil the criteria of an OCA. This country group – in current Euro crisis speak – consist of the core countries or countries of the North-Euro which have weathered the “Great Recession” of 2009 and the following Euro crisis relatively well. The most recent crises, however, have put off the track, politically and economically the countries in the periphery of the Euro area, the so-called South-Euro countries (Greece, Ireland, Italy, Portugal, Spain, the so-called PIIGS). The rest of members of the Euro area consist of a third group of new EU member states: Estonia, Slovakia, Slovenia, Malta and Cyprus (the latter has been rescued in March 2013 by a combination of bail-out (ESM plus IMF financial aid) and bail-in (participation of holders of savings accounts in Cyprus banks)).

In order to avoid a state insolvency because of over indebtedness, the EU/Euro area member states started the first rescue operation with Greece in May 2010 (followed by a second one in March 2012), consisting of ad hoc actions of bilateral credits, later in the cases of Ireland (December 2010) and Portugal (May 2011) with the provisional rescue instrument EFSF and later in the case of Spain (December 2012) and Cyprus (March 2013) with financial support out of ESM. With these rescue operations – under a very loose interpretation of the no-bail out clause of Article 125 TFEU – the EU/Eurozone embarked into a “Transfer Union”. One does not know how much of the credits of the donor countries given to the periphery countries could become “bad” or “nonperforming loans”.

Hence, the Euro area of 17 member states is currently artificially kept alive via transfers. Economic optimality is dearly bought by political optimality.

The current Euro crisis can be overcome only by two theoretically clear solutions: Either the Euro is given to all EU member states or one resizes the Euro area (break it up) to become an OCA.

What is the rationale for a policy of "Euro for all"? If the current Eurozone can be kept alive only with transfers from North to South (Barroso, Merkel and Draghi – defend the Euro project forcefully) then one should have the courage to envisage the "grand solution" and give all EU member states the Euro (see Breuss, 2013B). Of course we would then not have either an economic OCA but via the "Transfer Union" we would at least converge to the normality of a monetary regime which bases on the principle of "One country, one money". We could overcome the separation of the EU into a Euro area and a non-Euro area and hence the destructive option of non-Euro countries to devalue against the Euro within a Single Market. The political pressures would increase to finalize the missing elements of an Economic and Political Union. Finally, "one money for one country" would only be viable if the existing EU as a unification of sovereign nations would cross over to the United States of Europe. Only in this utopian status Europe would play its proper role in the globalized world with the Euro as the "face of Europe".

3.6 ... or the break-up of the Eurozone

The other theoretically clear solution to solve the Euro crisis would be a strategy to resize the Euro area, i.e. to break it up into to a core of countries (e.g. the former DM block) which then would form (hopefully) an OCA and into a group of countries which would introduce again their own currencies to solve at least its competitiveness problems. Although this sounds economically the optimal solution it is, nevertheless, politically not feasible. The program countries in the Euro area periphery, i.e. those which currently profit from a rescue operation will probably not agree to exit the Eurozone. Besides political there are also legal hurdles. The Treaty of Lisbon (TFEU) allows in Article 50 only an exit from the EU, but not one separately from the Euro area. The economically meaningful resizing of the Euro area ("Break-up of the Eurozone") would also

be a political confession of failure. Furthermore, the break-up of the Eurozone into a Nord-Euro and a South-Euro would have incalculable economic implications (a revaluation of the core countries, drastic devaluations of the leaving countries; unclear creditor-debtor relationships etc.; about the immense negative consequences of a break-up of the Eurozone, see Breuss, 2013A). A small Euro area would have made sense at the start of the Euro project in 1999, an ex post reversal of the whole EMU project is nearly impossible and boils down to the question "can scrambled eggs be separated again"?

4. The United States of Europe

At the end of all the developments towards "more Europe" one could imagine in a far future the utopia of the "United States of Europe" (USE)! Well this would imply politically a qualitative jump from the status of the EU as a "union of sovereign states" to the transfer of national sovereignty at EU level to form a European State. The question whether the EU has already reached the status of a quasi state (and which institutional set-up – a two chamber system like in the United States or a European twitter solution) was already intensively debated during the EU Convention on the Future of Europe in 2002/03 which ended in drafting a "Treaty Establishing a Constitution for Europe" (TCE). Exactly because of the fear that the EU elites with the TCE want to create a European "super state" on 29 May 2005 the French public rejected the Constitution by a margin of 55% to 45%, and three days later on 1 June 2005 the Dutch rejected the Constitution by a margin of 61% to 39%. As a consequence a second best solution, the Lisbon Treaty substituted the TCE, incorporating the majority of elements of the TCE but within the context of two Treaties, the TEU and the TFEU. One clear winner of the Lisbon Treaty was the European Parliament as it increased considerably the power in the co-decision process of EU law. Besides that the EU won international status by introducing the jobs of a President of the European Council and a "Foreign Minister" (High Representative of the Union for Foreign Affairs and Security Policy).

The Lisbon Treaty is the 5th revision of the founding Treaties of Rome (Treaties establishing the European Economic Community, EEC; and the European Atomic Energy Community, EAEC), having entered into force on 1 January

1958. In July 1967 the executive bodies (the Commission and the Council of Ministers) of all three communities (European Coal and Steel Community, ECSC, having entered into force on 23 July 1952 expired on 23 July 2002; the EEC and the EAEC) were merged in a Merger Treaty. Since then one speaks of EC (European Communities). The Single European Act (SEA) was the first major revision of the Treaty of Rome. The Act, into force in July 1987 set the EC an objective of establishing a Single Market by 31 December 1992. The next major revision of the EC was brought about with the Maastricht Treaty, entering into force on 1 November 1993. It created the European Union (EU) with the Treaty on European Union (TEU) and led to the creation of EMU with the Euro. For the first time, the primary law of the EU is based on two Treaties, the TEU and the Treaty establishing the European Community (TEC). The third revision of the founding Treaties was brought about by the Amsterdam Treaty, entering into force on 1 May 1999. It emphasis a greater role to employment policy and incorporated the Schengen Agreements into the legal system of the EU. The 4th revision was implemented by the Nice Treaty, coming into force on 1 February 2003. It was the basis for preparing the big 5th EU enlargement in 2004 and 2007. After the democratic refusal of the TCE, as a compromise the Lisbon Treaty, was put into force on 1 December 2009. Due to the shock of the "Great Recession" in 2009 and the following Euro crisis it turned out that shortly after its implementation the new EU Treaty was already obsolete, in particular concerning the necessary crisis management of EMU. Nevertheless, the Treaties legalising EU integration since the late 1950's until today document the underlying trend of an ever deeper (and complex) integration with a growing number of member states.

If one has the elitist and utopian ambition to establish the USE (see also Habermas, 2011; and many other EU friendly thinkers) one must confess that the European public is not yet ready to the changeover from nation states to the USE. Respective surveys proof this general mood against "more Europe". Furthermore, one can observe that the public acceptance of the of EU integration declines with its deepening from Treaty to Treaty.

This process can be noticed first in the case of the implementation and ratification of the Maastricht Treaty. It made a great leap ahead with the creation of the "European Union" (the first proposal to create a "Political Union" was refuted by the UK) and the establishment of a single currency (the Euro) in the EU with the EMU project. Three countries held referendums on the ratifi-

cation of the Maastricht Treaty: France, Ireland and Denmark. Because suits were filed against the Treaty at the German Bundesverfassungsgericht and its affirmative decision ("Maastricht Judgement"¹) was announced only on 18 October 1993, the Treaty could come into force only delayed on 1 November 1993. Ireland's public rejected in the 1st referendum the Treaty on 3 June 1992 and accepted it in a second round on 18 June 1992 only after the EU made concessions concerning participation in the common security policy. In France the Treaty was verified with a slim margin of victory of 51.1% on 20 September 1992. In Denmark, two referendums had to be held before the treaty of Maastricht passed. In the first vote on 2 June 1992 the Maastricht Treaty was denied by a slim margin, with only 49.3% in favour of the Treaty. After renegotiation Denmark received four opt-outs from portions of the Treaty (EMU; Union Citizenship, Justice and Home Affairs and Common Defence). In a new referendum on 18 May 1993 56.8% voted in favour of the renegotiated treaty. And in the context of the next Treaties (Nice and Lisbon) Ireland only voted in favour of ratification after having got concessions in one or the other areas of deeper integration.

All the hitherto experiments to push political EU integration further towards "more Europe" failed at the hurdle of national faint-heartedness. And the Euro crisis has aggravated this anti-EU mood. For many EU/Eurozone member states (in particular in the periphery), Germany by its size and economic power has become the "accidental empire" (Ulrich Beck) or "hegemon of Europe" with a political stance coined "Merkiavelli" by Ulrich Beck. Hence, one can only wait until the EU/Eurozone has recovered from the current crisis and a more optimistic economic and political outlook emerges. Only in the far future one can think again to finish the USE project. One must only be reminded of the huge gap in EU thinking in United Kingdom – from the vision of a "United States of Europe" in the speech by Winston Churchill in 1946 to David Cameron's EU speech in January 2013, announcing a referendum in 2017 with a simple

1 The German Constitutional Court (Bundesverfassungsgericht) stated in its "Maastricht Judgement" (BVerfGE 89, 155 as of 12 October 1993, Az: 2 BvR 2134, 2159/92) b) that the participation (of Germany) in a supranational Union is not in breach of the principle of democracy as long as the European Union obeys own democratic rules. It coined the notion "Staatenverbund" (union of states) in order to characterise the current status of the European Union. Although the EU owns sovereign democratic rights it is no pure "Staatenbund" (confederation) and because it does not rely on an own single public it cannot be classified as a "Bundesstaat" (federal state).

choice of “in or out”! Whereas Churchills vision was a united Europe (although without UK), Cameron prefers Europe à la carte and could lead to a “Brexit”.

5. Conclusions

European integration has reached such a high level with complex institutional, political and legal arrangements that a break-up of the EU is nearly impossible. On the one hand the Treaty on European Union (TEU) under “Common Provisions” (Article 1) pleads for an “ever closer union” when it states: *“This Treaty marks a new stage in the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as openly as possible and as closely as possible to the citizen.”* On the other, for the first time, Article 50 of the Treaty on the Functioning of the European Union (TFEU) offers the option to leave the EU (*“Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.”*). The United Kingdom, probably, could be the first Member State selecting the latter option in 2017. Maybe the UK will shrink himself when Scotland will become independent before.

Besides these more actual crisis-driven speculations one should not forget the long-term trend of European integration. And this is clearly towards more Europe. Since the outset of the Euro crisis in 2010 the EU/Eurozone is already much richer and more coherent in its policy design, in particular concerning EMU than it was before the crisis. Some elements (Banking Union) are still missing but the new economic governance has already created a “new EMU”. The next big qualitative leap would be to transform more sovereignty from the Member States at EU level. Finally – in the far future – we will witness a democratically legitimized United States of Europe where all Member States pay with the Euro.

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Europa 2050 – the best is yet to come!

Michael Eilfort, Verena Mertins

Europe - A Success Story

Europe and crisis - since 2009 those two terms are almost used synonymously. State debts, financial markets, individual national economies, the euro or even the entire European Union are associated with the term crisis. But by adopting such an attitude one tends to forget that the European Union was in large parts a real success story.

Since the creation of the European Coal and Steel Community in 1951 by the six States Belgium, France, Germany, Italy, Luxembourg and the Netherlands, the European unity has been more and more institutionalised. The number of Member States of the European Union (EU) founded in 1992 will in July 2013 reach 28. Geographically the EU reaches today from the Portuguese Atlantic coast to the Black Sea and from Northern Finland to Cyprus. Since the regrouping of the French and German coal and steel production and the creation of a free trade zone the economic co-operation has been progressively intensified and engendered a single internal market characterised by four fundamental freedoms (free movement of goods, persons, services, and capital transactions). Today the European institutions regulate important sectors of the economy, i.a. agriculture, fisheries, and competition policy, and there is a strong co-operation in the areas of justice, home affairs, and foreign and security policy. However, the most recent achievements turn out to be the most problematic ones: The euro, which is the common currency for 17 European States, and the European Central Bank, which is responsible for the common monetary policy within the monetary union.

Also in the future a European Economic Union will be an unavoidable player to be reckoned with in the global competition with the booming emergent countries which benefit from huge home markets. Its competitors are economic areas

in Asia, Africa, North and Latin America. European enterprises profit from the export and production opportunities offered by the single market. Thus 57% of German exports and 68% of Austrian ones go to countries of the European Union.

Not only from a strictly economic point of view a further development of the EU is inevitable. During many centuries Europe's past has been characterized by conflicts, culminating in the two World Wars. Since the end of World War II in 1945 and the end of the Cold War in 1990, wide parts of Europe enjoy a remarkable period of peace. European countries are not only united by their common history and their geographical situation but also by exceedingly strong societal similarities. There exists for instance a consensus about the importance of a social protection floor. The specific forms of the welfare State vary, for instance between Great Britain and Eastern Europe on the one hand and the Nordic countries on the other hand, but there is a common European commitment to social protection and to a certain income redistribution by the State. By contrast, for instance in the U.S. there exists no societal consensus about a State-guaranteed health insurance and in many emerging and developing countries there is hardly a social protection floor provided by the State, a fact that is partly, but not exclusively, due to the lower prosperity levels. In Europe a broad consensus about the necessity of a comparatively extensive income redistribution is evident, for instance in the form of a progressive taxation of income. In other parts of the world societies more readily accept marked disparities between the rich and the poor, be it an expression of superior individual performances or of inherited wealth.

Furthermore the European States are united by a common understanding of the rule of law, human rights, tolerance and freedom of the individual. Europe lives its cultural diversity based on the coexistence of different nationalities, religions and linguistic groups.

The European present is shaped by the common aspects of everyday life. Due to low-cost air travel and interrail, traveling within Europe is relatively cheap. Pupils and students learn about day-to-day life in European neighbouring countries through exchange programmes, like the Erasmus programme, in which 200,000 students participate each year. Within the European educational élite, professional and personal mobility are increasing. While just a few years ago a stay abroad was an asset for a job application, it is now con-

sidered an absolute necessity. Friendships and contacts are maintained and cultivated across national borders via social networks and internet chat or skype. But also mainstream Europeans are looking beyond the borders now. Italian cuisine, Irish pubs, Belgian chocolates, Swedish furniture, plants from the Netherlands, school trips to Prague or London - often the only question is whether the vacation is spent in France or Greece or if Spanish or German soccer is the measure of all things.

The European Union is in a crisis situation: Where are the problems?

The former successes and the European way of life, which is largely taken for granted, should not mask the serious present problems due to the economic and debt crisis. Although States like the U.S. and Japan are also faced with considerable national debts, household deficits, and the problems associated with them, the media are focussing on the crisis within the EU and the purportedly inadequate tentatives to cope with it. Is such a reductionist view really justified?

To answer this question, an analysis of Europe's problems is essential. In the short and in the medium run, the greatest challenge for Europe is to cope with the financial and debt crisis. On a long term basis, above all the imbalances between Member States regarding public debt, competitiveness, current accounts, and unemployment rates represent a problem. In a common monetary union there is no monetary policy and exchange rate mechanism to compensate for these imbalances. These macro-economic challenges are influenced by demography: Europe's population is ageing and shrinking. Most States have yet to adequately adapt their Social Security systems to this demographic development and will therefore have to face significant financing problems in the future. A targeted migration policy could represent a solution for the foreseeable need for skilled personnel, but is not a panacea.

But also from the politico-economic perspective Europe's future is viewed critically. The EU is faced with an image and marketing problem. To the national populations the European institutions appear remote and overly bureaucratic. Many citizens take the positive achievements of the EU for granted, but perceive Brussel's decisions as an inadequate interference. The media coverage

is focussing on absurd decisions, like the ban of light bulbs, the standards for water-sparing shower heads or the envisaged ban of refillable olive oil bottles in restaurants. In addition, an ordinary citizen does not grasp which mechanisms have generated the fiscal and debt crisis, which specific aid measures have been adopted and which financial consequences this will entail for the Member States. The frustration of the citizens concerning the European level is often linked to the democratic deficit of the European institutions. For instance the Commissioners are nominated by the national governments, are approved by the European Parliament and are then largely independent in their decisions. That is why there are claims to bestow more power on the European Parliament as a directly elected representation of the people. But this raises the question of a just representation of the population since presently small States are significantly overrepresented because they get more seats in relation to their number of citizens than bigger Member States. But in particular in the EU's dealing with the financial and debt crisis it seems that the European Council, consisting of the elected heads of State and government of the Member States, has increased its power vis-à-vis the Commission.

Public debt in Europe: Why it's even worse than initially thought

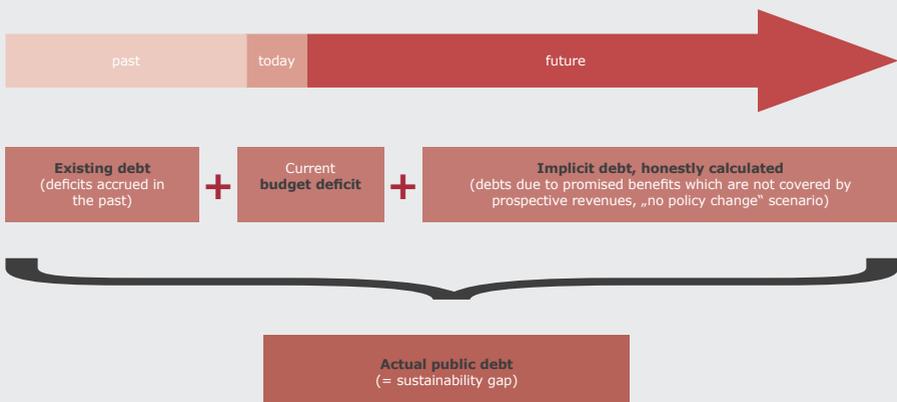
At the latest, the outbreak of the Greek debt crisis in 2009 has shown to the general public the great importance of the public debt of a State. A State with a huge sovereign debt has to spend a high percentage of its total expenditure for the payment of interests, which on the one hand reduces its room to manoeuvre in other policy areas, and, on the other hand, can threaten its long term solvency. But it is not sufficient to evaluate the national debt of a State in terms of its actual deficits and the current amount of the debt as an expression of the accrued public household deficits. For already today it is possible to estimate certain future developments which will have grave repercussions on the State budget. On the basis of these calculations the need for action in the spheres of fiscal and social policy can be evaluated.

Demographic change influences the future of the public debt because it impacts both the revenues and the expenditures. Due to the ageing of the population the proportion of the working age persons declines and consequently

also the absolute number of active persons. This means that taxes and social insurance contributions collected from the active population will drop and this, in turn, directly impacts public revenues. Furthermore negative effects on economic growth can be expected, which will again contribute to a drop in revenues. On the other hand, on the expenditure side the ageing of the population will most likely result in a significant increase in age-dependent public benefits, particularly expenses for pensions, health care and nursing. That is why legally binding commitments regarding pension rights or health and nursing benefits are important factors for the correct calculation of national debt. They do indeed affect future budgets, but not many States make provisions for these financial obligations or bear in mind, in their promises to the voters, the demographic trends and their consequences for the national budget.

The figures for the implicit government debt show to which extent future expenses are not covered by prospective revenues or existing reserves. It is a clear indicator of the necessary extent of either future rises of taxes or social contributions or else of cuts in the State's expenditures for social services.

Figure 1: Actual public debt – schematic representation



The Market Economy Foundation has calculated the explicit and the implicit debts for all Member States of the EU 27 which are the basis for the sustainability ranking presented in Table 2. The sustainability gap is an indicator for the actual amount of the national debt based on the status quo in a “no policy change” scenario. For the large majority of the countries considered here, the implicit debts are higher than the explicit ones, i.e. the debt already visible today. This is the reason why the consideration of the explicit debts gives an impression that is too optimistic. By the way, the amount of the explicit debts does not allow to draw conclusions about the amount of the implicit debts, which is why Luxembourg has a relatively bad ranking (last but one) and Italy a relatively good one (first in the ranking).

Table 1: Sustainability ranking of the EU States (basis year 2011)

Source: European Commission, AMECO Database, Eurostat.

Calculations: Forschungszentrum Generationenverträge

		Implicit Debt	Explicit Debt	Sustainability Gap	Consolidation Need
in % of the GDP					
1	Italy	-123	121	-2	0.0
2	Latvia	-42	43	0	0.0
3	Estonia	75	6	81	1.2
4	Poland	74	52	126	2.1
5	Germany	55	81	136	2.9
6	Bulgaria	160	16	176	3.0
7	Sweden	138	39	177	2.4
8	Portugal	73	108	181	3.2
9	Hungary	109	81	190	3.2
10	Romania	234	33	267	5.4
11	Lithuania	264	38	303	5.4
12	Austria	242	72	315	5.1
13	Malta	253	71	324	5.5
14	Czech Rep.	379	39	418	6.8
15	France	356	86	442	5.7
16	Denmark	396	47	442	6.5
17	Finland	420	49	469	6.6
18	Slovakia	506	43	549	8.4
19	Netherlands	499	65	565	9.3
20	Great Britain	550	88	639	7.0
21	Belgium	558	98	655	8.3
22	Slovenia	620	47	667	10.3
23	Cyprus	764	71	835	10.7
24	Spain	735	69	805	10.4
25	Greece	720	171	891	14.3
26	Luxembourg	1209	18	1228	13.4
27	Ireland	1271	106	1378	9.2

The calculations are based on the actual economic and fiscal situation in the year 2012. The GDP growth forecast is based on the potential growth assumed by the European Commission in its Ageing Report (AR) 2012. For the age-related expenditures – other than expenditures for pensions – an evolution as described in the AR 2012 is assumed. For the evolution of the expenditures for pensions a mean value between AR 2009 and AR 2012 is assumed, provided the increase of the pension expenditures according to AR 2012 is inferior to the increase according to AR 2009. After the year 2060 (maximum projection period in the Ageing Report) it is assumed that the part of the age-related expenditures in the GDP will remain constant.

A durable solution for the European public debt crisis is not possible without a thorough consolidation that includes the implicit State debts that are not yet visible. The last column of Table 2 shows the consolidation need, i.e. the amount (in % of the GDP) by which the State expenditure will have to be durably diminished or by which the State revenues will have to be durably increased in order to close the sustainability gap.

For Germany, 2.9 % of the GDP would represent an annual need for diminishing the expenditure/increasing the revenues by 75 billion euro if a permanently balanced budget is to be obtained; this amount takes into account the unfavourable demographic evolution.

The European Union in the year 2050 – strength in diversity

Europe's strength is its – political, cultural and economic – diversity. The EU's enlargement further increases the differences in Europe and underscores its diversity. This development should be seen as an opportunity that should be exploited in a constructive spirit. On the other hand, an excessively centralised economic policy that tries to impose a single economic model on all European States squanders a great deal of potential. By the way, it is to be expected that an excessive centralisation will lead to a smaller EU. In Great Britain there is already a discussion going on about a popular vote on the country's withdrawal from the Union. In the Nordic and the Eastern European countries eurosceptical parties become increasingly popular. From today's perspective, it is the debate in Great Britain that is of particular concern, since the United Kingdom's withdrawal would weaken the EU, and Germany and the other stability-minded States would thereby lose an important partner with similar political interests. But that is not the only reason why an excessive centralisation, that would exclude some countries, is not advisable. Different States have different economic structures, geographic and historic particularities and preferences, e.g. specific tax and Social Security systems. The competition between countries clearly reveals the strengths and weaknesses of the different national economies. Since the European Union as a single economic area is involved in a global competition with other such big groupings, its internal competition improves its own overall competitive position.

So what is the role of the EU within this vision of the future of an economically strong and diverse Europe?

In the year 2050, the EU and the Eurozone will not be a transfer union. Already at the level of the single States it is difficult to impose such a transfer

union. Even 20 years after Germany's reunification the old Länder complain that the resources that they have to transfer to the new Bundesländer are lacking when it comes to maintain their own infrastructure. Italy's economically strong Northern Regions oppose permanent transfers to the South, and in South Tyrol this opposition even takes the form of an independence movement. A broadly based European transfer union as a permanent fixture would sooner or later cause the blowing up of the EU. The donor countries would accuse the recipient countries of laziness and insufficient commitment, and they in turn would be confronted with the accusation of not showing solidarity. Nationalistic parties would successfully hunt for votes and this would lead to withdrawals from the monetary union or even from the EU.

It is basically justified that on the markets for European government bonds interest rates vary considerably according to the perceived differences in the solvency of the individual States. Here too - as in every other sub-sector of the financial markets - the creditors must be conscious of the fact that they will have to assume certain risks. Within the system of a market economy, risk and responsibility are intrinsically linked, otherwise profits would be privatised and losses and risks passed on to the community.

"Solidarity" and "solidity" belong together. The Monetary Union will only be a sustainable success if the basic principle of "no bail out" is credible. Transfer payments should not be institutionalised but should only be granted on an ad hoc basis and act as "help for self-help". This is why the debate over the alleged opposition between austerity policy and growth policy is misleading. Europe needs both, but they will have to be combined judiciously. Countries with a huge public debt have no choice but to impose a rigorous austerity policy and to look for a possible hair cut on their debt if they want to regain a greater financial scope for action because only a successful consolidation and a reduction of their structural deficits will create the necessary environment for a sustainable economic growth. If they want to re-enter the growth path they will have to implement structural reforms and develop a sustainable national business model. But structural reforms are a time consuming process. The positive effects of reforms of, for instance, the labour market, the Social Security system and the tax collection do not become visible overnight. Nevertheless, Greece's most recent macro-economic data show already now - four years after the true dimension of the

country's debt has become visible and the national crisis broke out – the first results of the structural reforms, e.g. as far as economic growth, competitiveness (as measured by unit labour costs), and current account balance are concerned.¹ That means that sooner or later structural reforms and an improvement of the macro-economic environment – and thus of the competitiveness of a country – will lead to an upward turn in the development of its economy.

Sustainable budgetary policy as a result of a Stability Union

In the year 2050 Europe will no longer be a continent of debt sinners. After several decades during which the politicians have handed out, with an astounding matter-of-factness, credit-financed benefactions there will be a paradigm shift in the different States: They will have a democracy without distribution of gifts, and, in principle, balanced budgets. Since the spring of 2010, the debt delusion, which consisted in believing that it would be possible to continue to lead a comfortable life on tick and to pass on the debt to future generations, has been unmasked as an aberration – even if there remain still some who refuse to recognize the obvious facts.

For a Monetary Union to function, each and every Member State must pursue a sustainable budgetary policy. In 2050, Europe will be a union of individual nation States operating on a sound fiscal basis, and the euro will be a currency underpinned by a solid economic performance and a true competitiveness - or else there will be neither a union nor a euro. This is why recommendations issued by the EU and regarding the consolidation of the Member States' budgets make sense. And in view of the debt crisis it equally makes sense to invite Member States with a relatively solid financial status to consolidate their budgets even beyond their legal obligations.² Nevertheless, the national autonomy in matters concerning the practical implementation of the budget consolidation should be maintained. It should be within each State's responsibility to decide if

1 Cf. Matthes, Jürgen (2013), Griechenland: Silberstreif am Horizont?! Eine kurze Reformbilanz, IW policy paper, Nr. 4.

2 Cf. e.g. Council Recommendation of 10 July 2012 on the National Reform Programme 2012 of Germany and Delivering a Council Opinion on the Stability Programme of Germany, 2012 - 2016.

it prefers to diminish its expenditure or to increase its revenues by raising specific taxes, since – as we already said – there are major differences between States as far as their preferences and structural conditions are concerned.

Strict general rules imposed at the European level for the States' fiscal policies, e.g. in the framework of the Fiscal Compact that obliges Member States to introduce national debt brakes as well as the more stringent preventive and corrective components of the Stability and Growth Pact decided in 2012, represent also meaningful tools. In the aftermath of the debt crisis and in the framework of the European Semester the scope of the budgetary co-ordination and the monitoring of the Member States have been intensified.³ This makes sense because it involves the Commission at an already early stage in the national budgetary procedures and enables it to detect negative developments and to initiate corrective actions where appropriate.

For a successful implementation of the European Monetary Union in a long term perspective, the "Kronberger Kreis" (the Scientific Council of the Market Economy Foundation - Stiftung Marktwirtschaft) proposes a "Maastricht 2.0", i.e. a Stability Union under national responsibility but based on unalterable fiscal policy rules.⁴ European fiscal policy rules should have sufficient binding effects in order to guarantee sound fiscal policies in Europe, but at the same time maintain a minimum of options for the individual States. The ultimate responsibility for the fiscal and economic policies rests with the Member States. The national stability policy must be based on a large political consensus.

"Yes" to a economic policy co-ordination – "No" to central planning imposed by Brussels

While the tightening of the fiscal policy rules and the greater use of automatism is to be welcomed without restrictions, the monitoring of macro-economic imba-

3 Cf. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2012), *Stabile Architektur für Europa – Handlungsbedarf im Inland*, Jahresgutachten 2012/13.

4 Cf. Kronberger Kreis (2012), *Wie viel Koordinierung braucht Europa?*, Studie, Nr. 55, The Market Economy Foundation (ed.), Berlin.

lances by the European Commission in the framework of the European Semester should undergo a critical evaluation. On the one hand, an extended macro-economic monitoring makes sense, because excessive macro-economic imbalances, e.g. as far as unit labour costs, bank lending, real estate prices, and public and private debt were concerned, have been major causes of the European economic and financial crisis.⁵ Within the macro-economic monitoring it is possible to detect, at an early stage, the need for reforms in the economic policy as well as risks for the fiscal management. Since it is a European institution that asks for reforms, the Member States that have been criticized can hide behind the EU and denounce it as a scapegoat when they are obliged to impose necessary but unpopular reforms. This can be helpful for the enforcement of reforms but engenders also the risk of a further deterioration of the EU's image within the population.

On the other hand there exists the risk that the Commission uses the procedure to combat macro-economic imbalances to try to intervene in a manner reminiscent of central planning. This could have a negative impact on the competitiveness of the Eurozone as a whole if the above mentioned individual models and strategies that govern the economic policies of the different States, e.g. in such domains as economic structures or social redistribution, are not sufficiently taken into account. A too strong centralisation would lead to a uniform mediocrity on the European level which would not be conducive to an enhancement of the competitiveness of the EU as a whole.⁶

For this reason a true European economic government must also be opposed, since this would imply the devolution of important powers in the field of economic policy from the Member States to the EU. The competition between the EU Member States, with their individual finance, employment and other economic policies, serves as a detection procedure that highlights particularly successful solutions in the fields of economic policy and economic governance.⁷

5 Cf. ECB (2011), The reform of economic governance in the euro area – essential elements, Monthly Bulletin, March 2011.

6 Cf. Eilfort, Michael und Verena Mertins (2013), Stellungnahme der Stiftung Marktwirtschaft zum Thema „Europäisches Semester“, 87. Sitzung des Ausschusses für die Angelegenheiten der Europäischen Union, 17.04.2013, Ausschussdrucksache 17(21)1532.

7 Cf. Eilfort, Michael und Verena Mertins (2011), Schuldenkrise bewältigen - ohne Transferunion!, in: ifo Schnelldienst, Nr. 3, S. 17-20.

A stable euro as a result of an independent monetary policy and a better regulation of financial markets

In order to permit the euro to celebrate its 50th anniversary in 2052 and to be used as one of the major global reference currencies in addition to the US Dollar and the Renmimbi, the European Central Bank (ECB) should follow the success stories of the German Bundesbank and of the Deutsche Mark. The true role of the ECB is to function as an independent central bank pursuing, as its major goal, the stability of the common currency. In July 2012 the announcement of the President of the ECB, Mario Draghi, that the Bank would do its utmost in order to save the euro, showed the intended effect in a first phase and did effectively calm down the financial markets. But the purchasing of government bonds issued by the „crisis States“ creates in the longer run a dangerous inflationary potential⁸ and has, as an immediate effect, contributed to politicize the ECB: Such a political favour (by the way granted without any democratic legitimacy) must inevitably engender others of the same nature.

Far-reaching capital requirements beyond those stipulated by the Basel III rules are an efficient instrument for a long term stabilisation of the European financial markets. On the other hand, imposing higher taxes on banks does not reduce the systemic risks. The debt crisis has shown that even supposedly safe government bonds have a default risk. That means that banks should back them by equity capital in the same way as any other debt instrument. In addition, the European banking supervision authorities should be strengthened, in particular by putting at their disposal the necessary macro-economic know-how.⁹

8 Cf. Neumann, Manfred J.M. (2012), Die Europäische Zentralbank auf Abwegen, Argumente zur Marktwirtschaft und Politik, Nr. 116, Berlin.

9 Vgl. Kronberger Kreis (Scientific Council of the Market Economy Foundation)(2011), Systemstabilität für die Finanzmärkte, Studie, Nr. 53, Stiftung Marktwirtschaft (ed.) Berlin.

A single labour market

A well functioning single labour market with an unrestricted competition between the employers for the best workers and an equally unrestricted competition between the workers for the best jobs: this should be the vision for the year 2050. Especially in recent years we have seen that the much-cited language and culture barriers do not discourage well educated young Southern Europeans from seeking jobs in other countries than their own. In a first phase this is advantageous for themselves and for the employers who recruit them. Although the crisis States lose thus the most mobile well qualified workers, it can be expected that after some years they will return to their countries of origin where they will represent a valuable human capital and provide strong growth impulses for their national economies.

Much has to be done though in order to make sure that there is a single European labour market not only during periods of crisis and not only for a well formed élite. Improving the mobility of workers requires that professional qualifications and diplomas are more easily recognized. In certain countries - and this is also true for Germany - the ability of the general population to speak English should be improved. As far as the Social Security systems are concerned, there is an urgent need for action in order to make pension rights more portable and to be able to easily switch to foreign health insurers. European employment biographies require more flexible and more Europe-centred Social Security systems. The aim must be to make things less bureaucratic but not to have a completely harmonised labour law. The latter would indeed be detrimental to a sound competition between States and regions.

Europe in 2050 - a tremendous opportunity

For Europe to be successful also in the year 2050 it is necessary to have a good political and economic governance. A monetary union can only be successful if there are common basic principles for the fiscal policy that are respected by everybody. As far as the economic policy is concerned, it is possible to imagine some sectors where a closer co-operation is necessary.

In addition to the already cited tasks one could mention in this context the energy supply. This does of course not mean that Brussels should prescribe a uniform energy structure for all Member States. But an extension of the European network could contribute to a more secure and less expensive energy supply for everybody. Undoubtedly a combination of Norwegian and Austrian hydro-electric power plants, British and German offshore and onshore wind energy, Greek and Spanish solar energy, French nuclear power plants and Polish coal-burning power plants makes more sense than the goal of energy self-sufficiency for each European State.

“More Europe” is not necessarily a better goal for all our activities. Sometimes „less is more“ can also be a valid principle. “No” to the regulation of insignificant details, “No” to bureaucratic absurdities, but “Yes” to the principle of „strength in diversity“. Such a Europe does not need to have fears about its future.

Banking Union rather than Fiscal Union?¹

Daniel Gros

In September of 2012, around the height of the euro crisis, the four European presidents of the European Commission, the European Council, the Euro Group and the European Central Bank issued a joint report entitled: "Genuine Economic and Monetary Union".

The report was drafted after the European Council of June 2012 had already decided that in order to break the vicious feedback loop between sovereign debt and bank debt, a single supervisory mechanism should be established for large systemic banks – and that moving towards a federal supervision would require additional steps towards a federal resolution mechanism. These elements together came to be known as 'Banking Union'.

The four presidents argued that, in essence, the establishment of a Banking Union should also be seen as a first step towards further integration. According to their report a fiscal union would be the next logical step. Moreover, a fiscal union was taken to imply the need for a political union.

There is surprisingly little analytical argument for the nexus of a banking union–fiscal union. The key argument is most often simply the observation that the euro area has only a very limited central budget (at least if compared with other monetary unions), and that therefore there are almost no fiscal transfers to smooth asymmetric shocks. By contrast, the US, which is of a similar size to the euro area, does have a substantial federal fiscal budget. The US experience is thus usually taken as an example of what is needed for a sustainable monetary union. In short, the argument seems rather to suggest that a functioning monetary union requires both a banking union and a fiscal

1 An earlier abridged version of this article was presented at the European University Institute conference entitled "Political, Fiscal and Banking Union in the Eurozone?" on April 25, 2013.

union (and that the latter requires a political union).

It is indeed true that most existing monetary unions have a much larger federal budget (and constitute federal states, not loose confederations). But this was known when the architecture for EMU was drawn up in the early 1990s. It is often forgotten that there was a wide-ranging debate about this issue during the preparation for Maastricht (and it is surprising that the report of the four presidents does not contain any reference to this debate). The conclusion then was that the case for a fiscal shock absorber was not very strong, even if one looked to the US as a model, and that even if it might be useful in theory, it would be exceedingly difficult to implement in practice.

There is no scope to revisit the debate of the 1990s that led to the decision to start EMU with only a minimum degree of fiscal integration (See Chapter 8 of Gros and Thygesen (1992 and 1995) for more on this topic.) In this contribution I would like to draw attention to two aspects of the US experience, which are widely misunderstood but nonetheless crucial to the debate about the link between monetary union, banking union and fiscal union.

First, the federal budget in the US provides very little insurance against shocks, although the budget is an important income redistribution instrument.

Second, the 'banking union' of the US provides a very tangible insurance against local financial shocks.

That being said, as I see it the current discussion is about the alleged need to have a separate and additional fiscal shock absorber, where 'fiscal' is understood in a narrow sense as taxes and benefits not related to financial markets.

The Great Recession provides a very important episode from which we can assess the importance of shock absorbers. One reason for this is that the housing boom was very concentrated in the US (as it was in Europe). The increase in house prices varied enormously from state to state and a few states accounted for most of the overbuilding and thus the subsequent economic distress and losses from delinquent mortgages. Moreover, in normal times, it should be possible for most economic actors to use financial markets

to smooth consumption in the face of temporary shocks. However, the Great Recession coincided with a profound financial crisis that froze financial markets for some, excluding entire groups from access to lending. This means that fiscal shock absorbers would have been even more important during the Great Recession than during more normal business cycles.

1. What lessons from the US 'fiscal union'?

The argument for the need of a fiscal shock absorber at the euro area level has often been made with reference to the US experience. One frequently cited mechanism to provide such a shock absorber is a common (European) unemployment insurance scheme. Any reference to the US would be misleading in this case, however.

In the US, unemployment insurance is actually financed mainly at the level of states. While there is some de facto reinsurance at the federal level, in practice the federal reinsurance is not often used. It springs into action only in the case of large shocks. The Great Recession constituted one of those large shocks, indeed there has been considerable federal involvement in unemployment benefits over the last few years. But this support was given to all states and thus does not provide those states most affected by the downturn with much more support than the others.

Moreover, unemployment benefits are not as big as is often assumed. In most countries they amount to only about 2-3% of GDP, even during a major recession. In the US the supplementary federal expenditure amounted to only about 1% of GDP in recent years. It is thus clear that a euro area unemployment insurance system would never be able to offset major shocks such as those hitting Ireland or Greece, where GDP has fallen by over 10%.

Moreover, one has to account for the fact that in the US unemployment differences across states tend to be temporary, which is not the case in the EU (or euro area). Any common unemployment insurance system in the EU would thus risk leading to permanent transfers. This persistence in national unemploy-

ment rates (and thus the difference between the EU and the US) is understandable, given that most of the factors that determine the unemployment rate in the long run are social norms and regulations, which remain national in the EU. Unemployment insurance is, of course, not the only way to provide a shock absorber. A 'fiscal capacity' for the euro zone has thus been proposed. The key question is: Against what type of shocks should such a system be designed to insure?

If business-cycle shocks were really the key problem individual member states could first of all 'self-insure' by running a prudent fiscal policy and lowering their debt level so that they have the freedom to run temporary deficits in case they face temporary shocks. The 'Fiscal Compact', with its target of approximate balance in cyclically adjusted terms, is implicitly based on this idea.

However, the euro crisis has shown that the really important shocks result not from normal business cycle fluctuations, but from financial boom bust cycles that can put the entire financial system in jeopardy. Such shocks are less frequent than business cycles, but when they arrive they have a much greater impact. Before the outbreak of the financial crisis of 2007/8 normal business cycle shocks led to fluctuations in GDP of at most 1-2 percentage points. However, the 2008 crisis led to a fall in GDP several times larger and in the wake of the euro crisis some countries have experienced double-digit falls in GDP and have seen their entire financial system on the verge of collapse.

What kind of fiscal system could provide insurance against this type of shock?

Most proposals for some euro area fiscal shock absorber mechanism are grounded in the perception that in most existing federations, the federal budget redistributes income across regions and thus offsets at least part of the interregional differences in income. While this has been repeatedly documented for the USA (for some older references see MacDougall (Commission of the EC, 1977) and Sachs and Sala-i-Martin (1992)), the inference that redistribution is equivalent to a shock absorber mechanism is wrong.

The research cited above concluded that the US federal budget offsets about 30–40% of the differences in the level of income per capita across states be-

cause poorer states contribute on average lower income tax and receive higher social security payments. However, this does not automatically imply that these mechanisms also provide an insurance against shocks (i.e., changes in income). My own work (see Gros and Jones, 1995) suggests that evidence of a high degree of stabilisation of income is in reality the result of the joint effect of the (automatic) stabilisation across states at any given point in time and of the (at least partly discretionary) changes in the federal fiscal stance, which stabilise income over time for all states together. The automatic stabilisation across states or regions accounts for less than one-half of the overall stabilisation, reducing the variability of personal income by about 15%. The federal fiscal stance turns out to have a stronger stabilising impact, and this was the case even during the Great Recession.

The degree to which the US federal fiscal system absorbs shocks at the state level cannot be very large, for the simple reason that the main federal source of revenues that does react to the business cycle (i.e. the federal income tax) accounts for less than 10% of GDP (as mentioned above, in normal times unemployment remains at the state level). This implies that, on average, only about one-tenth of any shock to state income is automatically absorbed at the federal level.

2. What lessons from the US II: Evidence from the 'Great Recession'

More recently I have looked at the distribution of federal expenditure and taxes by state within the US. To my surprise, I found that there was very little relation between the severity of the recession at the level of individual states, measured by the fall in GSP or increase in local unemployment rates, and the amount of net federal transfers received (by residents of the state). As mentioned above, the differences in the shocks to GSP are as large as the difference among EU member states, given the regional concentration of the housing boom in the US.

The federal deficit has, of course, increased by several percentage points of

GDP, which implies that on average in most states residents have received more federal fiscal expenditure than they (or rather their residents) have paid in federal taxes. Yet, it is striking in particular that (the residents of) those states hardest hit by the real estate boom/bust cycle (like Arizona or Nevada, which thus suffered the highest increase in unemployment and large falls in GSP) did not receive more net federal transfers than others.

These findings reinforce the conclusion that, all in all, it is difficult to rest the case for some euro area shock absorber based on the US experience.

I would add that the distinction between transitory and permanent shocks becomes crucial in this area because any permanent shock requires adjustments in real wages and/or migration, rather than permanent financing. Moreover, it is difficult to see how one could provide insurance against permanent country-specific shocks without directly addressing the issue of income redistribution among member states.

3. What lessons from the US 'banking union'?

It is generally agreed that a fully fledged banking union (BU) has three elements:

1. Common supervision (this is now agreed in principle in Europe, with the ECB under the SSM = Single Supervisory Mechanism soon ready to start taking over supervision for most large banks).
2. A common mechanism to resolve banks. In Europe agreement on the so-called Single Resolution Mechanism (SRM) has been reached in principle once SSM works effectively.
3. Common deposit insurance. No agreement yet in Europe, but at least some reinsurance of national deposit insurers against catastrophic risks will be needed.

The US has had all three elements, at least since 1933. The US thus qualifies as a BU – and the consequences could be seen during the financial crisis. A simple comparison of the fates of member states of a larger monetary union that are hit by a financial crisis provides a powerful illustration of the impor-

tance of an integrated banking system. Ireland and Nevada provide an almost ideal test case. These two countries/states share several important characteristics. For example, they both have similar-sized populations and GDP, and they both experienced an exceptionally strong housing boom. However, when the boom turned to bust, Nevada did not experience any local financial crisis (nor did the state government have to be bailed out).

The key difference between Nevada and Ireland is that banking problems are taken care of in the US at the federal level (effectively a banking union), whereas in the euro area, responsibility for banking losses remains national.

Local banks in Nevada experienced huge losses and many of them became insolvent, but this did not lead to any disruption of the local banking system as these banks were seized by the Federal Deposit Insurance Corporation (FDIC), which covered the losses and transferred the operations to other, stronger banks. In 2008-09, the FDIC thus closed 11 banks headquartered in the state, with assets of over \$40 billion, or about 30% of state GDP. The losses for the FDIC in these rescue/restructuring operations amounted to about \$4 billion.

Other losses were borne at the federal level when residents of Nevada defaulted in large numbers on their home mortgages. The two federal institutions that re-finance mortgages have lost about \$8 billion since 2008 between them.

The US banking union thus provided Nevada with a 'shock' absorber of about 10% of GDP, not in the form of loans, but in the form of an (ex post) transfer because losses of this magnitude were borne at the federal level.

Moreover, much of the banking business in Nevada was (and still is) carried out by 'foreign' banks, i.e. by out-of-state banks, which just took the losses from their Nevada operations on their books and could set them off against profits made elsewhere. This is another way in which an integrated banking market can provide insurance against local financial shocks. Given that the large banks had a market share of about 50% in Nevada one can estimate that they provided another loss absorption of 10% of GDP.

The experience of Washington Mutual (WaMu) illustrates this general point. The biggest bank to have failed in US history, a mortgage specialist, WaMu had its headquarters in Nevada (although the name suggests otherwise) and some small operations there. However, its failure did not lead to any local losses as Washington Mutual was seized by the FDIC and its banking operations were sold for a very small sum to another large US bank (JP Morgan Chase) – but without any loss for the FDIC. Moreover, Washington Mutual received about \$80 billion in low-cost financing from the US Federal Home Loan Bank. If a bank like WAMU had been headquartered in Ireland the Irish government might have been held responsible for its losses as well.

In Europe, only the Baltic countries, whose banks are largely in foreign hands, benefited from a similar loss-absorption protection provided by the Scandinavian headquarters of their local banks. Conversely, most of the real estate lending in Ireland had been extended by local banks and the government had to assume their losses. Irish banks received massive amounts of low-cost emergency liquidity assistance from the European Central Bank, but the Central Bank of Ireland had to guarantee these loans, which was not the case for any bank in Nevada.

All in all it appears that in Nevada losses of the order of 20% of GSP were absorbed at the federal level.² If the plans for a euro area banking union are completed, the euro area could acquire an extremely effective shock absorber system.

4. Concluding remarks

The really important and costly shocks are financial boom–bust cycles followed by a financial crisis. These financial crises are rare and regionally concentrated (even within a ‘genuine’ monetary union like the US). What arrangement provides the best protection against these shocks?

2 See my note on the Nevada-Ireland comparison:
<http://www.ceps.eu/book/banking-union-ireland-vs-nevada-illustration-importance-integrated-banking-system>.

The US experience seems clear: the shock-absorbing power of explicit federal transfers is rather small, but the US Banking Union provides important support in case of large shocks to a local financial system.

This has one simple implication: what the euro area needs to insure its stability is a strong banking union, but not a fiscal union. The usual argument that a banking union needs to be followed by a fiscal union should thus be turned on its head: an area with a well-functioning banking union does not need fiscal shock absorbers and thus does not need a fiscal union. From the latter it follows that there is also no need for a political union. As long as the banking system is stabilised member states can remain responsible for their own fiscal policy. Excessive spending by member state could no longer de-stabilise the entire banking system. This implies that political responsibility for fiscal policy could remain at the national level.

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The Future of the Eurozone¹

Christian Keuschnigg

Introduction

Sharing a common currency holds great potential to stimulate trade, integration and growth in Europe. The elimination of exchange rate risks saves transaction costs and facilitates trade, allowing firms to exploit growth opportunities with easier access to a large common market. The Euro promotes the development of a common liquid capital market which boosts growth by reallocating capital towards those uses and regions where returns are highest. A more liquid capital market reduces interest, making it easier for firms and households to finance investment, housing and durable consumption. However, a common currency involves a loss of national sovereignty with at least two potential costs. First, the Euro permanently fixes internal exchange rates and thereby eliminates an important adjustment mechanism. Second, monetary policy is set by the ECB,² making it difficult to tailor it to individual country needs.

Large imbalances have built up since the Euro was introduced in 1999. The economic and financial crisis of 2008 triggered three mutually reinforcing crises in the Eurozone, sovereign debt, banking and current account crises, which emerge in different combinations in individual countries. Important reforms are implemented in the crisis countries as well as at the European level. This process must result in new institutions and rules so that all will be able to benefit from one currency and further integration. Reform and institution building must prevent free riding, cross-border externalities and beggar thy neighbor policies so that member countries no longer inflict damage on each other but rather benefit from developments in other regions. Credible rules to

1 I am grateful to Klaus Weyerstrass for insightful comments and ongoing joint work.

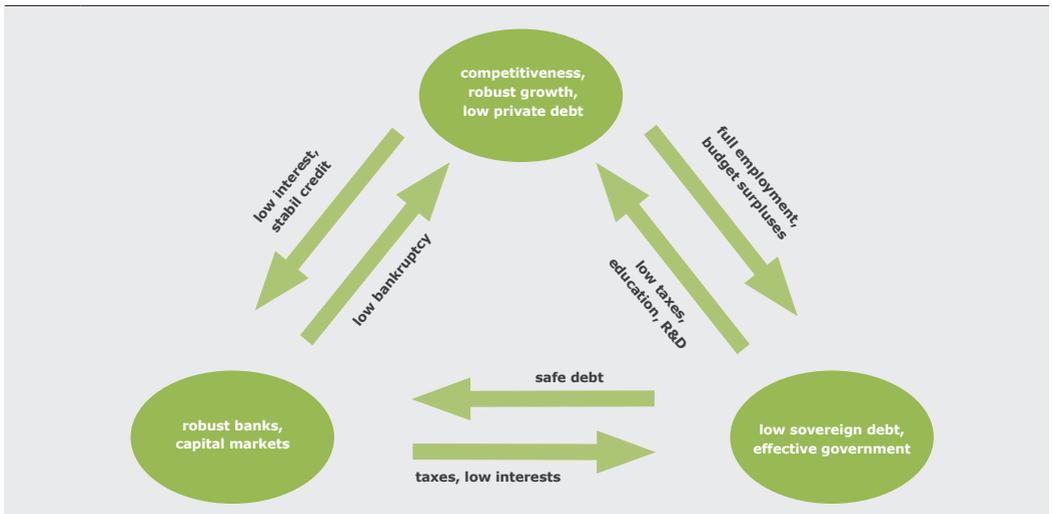
2 Abbreviations used in this essay are ECB European Central Bank, ESM European Stability mechanism, IMF International Monetary Fund, OMT Outright Monetary Transactions, ESBies European Safe Bonds, EDA European Debt Agency, ELA Emergency Liquidity Assistance.

bar self-serving policies at the expense of other members are a precondition not only for a better economic result but also for political harmony in Europe.

Crisis and Reform in the Eurozone

The crisis in the Eurozone is driven by a vicious cycle between competitiveness and growth problems, excessive fiscal debt and unstable banks. Economic reform and institution building must achieve a virtuous cycle of a mutually reinforcing interaction between competitiveness and growth, fiscal sustainability and stable banks with positive feedbacks as in Figure 1. The next three subsections turn to each area of reform.

Figure 1: Future of the Eurozone



Competitiveness, Growth and Sustainable Debt

The Euro eliminates national exchange rate adjustment to offset diverging productivity and competitiveness. In a currency union, another form of price and quantity adjustment must prevent current account imbalances lea-

ding to unstable foreign debt: wage and labor market flexibility, migration, and fiscal insurance with a larger central budget (see, e.g., Beetsma and Giuliodori, 2010; Buiters and Rahbari, 2011; De Grauwe, 2009; Feldstein, 2011; Keuschnigg, 2012; Lane, 2006; Lane, 2012; Sapir, 2011; Shambaugh, 2012; Sinn and Wollmershäuser, 2012). Since exchange rates are permanently fixed, external devaluation or revaluation for individual countries is no longer possible and must be replaced by internal adjustment via increased wage and labor market flexibility. More migration could contribute to economic convergence when labor flows from low to high income regions. A larger central budget could contribute to more fiscal insurance. A loss of gross income in a depressed region would be partly offset by lower outflows of taxes and larger inflow of social transfers from the central budget. Disposable incomes would fluctuate less than gross incomes. Due to different languages and cultural traditions, the potential for more migration is low, the preference for decentralization and national fiscal sovereignty is strong, and the willingness for large scale redistribution is limited.

If a country loses competitiveness, external devaluation makes exports cheaper on world markets and imports more expensive. Devaluation shrinks real income relative to foreign countries. Within the Eurozone, individual countries must instead devalue internally by reducing unit labor costs to get more competitive in the tradable sector. "Fiscal depreciation" by shifting the tax burden away from labor towards indirect taxes could also help to reduce unit labor costs (see Farhi et al, 2011). Internal devaluation leads to substantial income losses and unemployment but is unavoidable to eliminate external deficits. The capital market cannot extend new credit if a country is unlikely to generate surpluses in the near future to repay and refinance foreign debt. Internal devaluation is required to reallocate employment and investment from the non-tradable to the international sector to generate more export earnings and substitute for imports. For structural change to happen, labor market reform must allow termination of unprofitable employment as a precondition for new jobs in more competitive and profitable sectors. Transitional income losses diminish demand and production of non-tradeables much faster than new jobs are created in the international sector. The country experiences a severe adjustment recession with high unemployment which is reversed only slowly in pace with the expansion of the tradable sector.

If an uncompetitive economy were to leave the Eurozone, the exchange rate of the national currency would probably overshoot. A large one-off depreciation would immediately restore competitiveness and speed up new export led growth. Internal devaluation by wage moderation or even nominal wage cuts is much slower in restoring competitiveness which prolongs the adjustment recession and delays growth.

The Euro can neither devalue individually for uncompetitive deficit countries nor can it appreciate separately for very competitive surplus countries such as Germany. The Euro thus prevents terms of trade gains by surplus countries which would raise real income towards the rest of the world. External appreciation which would happen with national currencies in Germany and other surplus countries must be replaced with internal appreciation by means of higher wage increases to allow real income rising in line with productivity gains. The process must stop as soon as unemployment rises and current account deficits appear. Higher real income would stimulate demand in all of Europe. However, Southern deficit countries must first regain competitiveness to effectively attract a larger share of higher aggregate demand. Reversing past trends, prices must rise above average in the North and must stagnate or even decline in the South.

The current account crisis in Southern periphery countries is partly a result of capital market failure. Prior to the introduction of the Euro, Southern countries with low productivity growth were facing higher interest to compensate for the exchange rate risk. These risk premiums disappeared with the introduction of the Euro. No other risks were perceived in place of exchange rate risks. It seemed inconceivable that member countries of the Eurozone could become insolvent. Market participants expected that – in contrast to official statements – the community would always bail out member countries since insolvency would possibly endanger the existence of the currency union and would be more costly ex post than a bail-out. Given these expectations, credit was extended to periphery countries at the same record low interest rates that were offered to the strongest countries with highest ratings.

Easy access to credit with low interest in a generally expansionary environment fueled a large investment and real estate boom. Many of these investments would

not have been profitable had market rates included an adequate risk premium. Importantly, due to arbitrage possibilities with a common currency, the ECB can no longer set country specific interest rates to offset regional divergence. Rapid growth prior to 2008, financed with large capital inflows, encouraged wage and price increases much larger than in the Northern countries that were not backed by real productivity growth and continuously eroded competitiveness. The Euro became an overvalued currency for weak countries and was increasingly undervalued for strong countries such as Germany. These developments led to large private sector debt and, in some countries, public debt which contributed to large current account deficits and foreign indebtedness. Access to credit was abruptly stopped with the outbreak of the financial crises in 2008.

Rebalancing suffers from a key timing problem. Countries must gain competitiveness and eliminate current account deficits very fast to prevent further accumulation of foreign debt. Raising productivity by education and training, innovation and more labor market flexibility is a slow process. In the short-run, regaining competitiveness requires wage moderation and wage cuts to effectively reduce unit labor costs which have grown over many years much faster than productivity. Otherwise, investments in the tradable sectors will not be profitable and countries will not be able to attract FDI as a chance for new growth. The crisis countries need "bridge financing" until the economic transformation is complete, current account deficits are turned into surpluses to sustain foreign debt, and capital market financing is feasible again. Credit by the ESM and IMF is subject to strict conditions where new tranches are paid out only if key milestones of economic reform are achieved.

Once the adjustment process is completed, real wages can grow again in line with productivity gains without impairing competitiveness and creating current account imbalances. Wages will be able to catch up and grow faster only if a country invests more in education and training, encourages innovation, fights bureaucracy and corruption, creates efficient institutions and implements other growth enhancing reforms. If a country is not able to implement these structural reforms, it must accept to permanently earn lower income than other countries in the currency union.

In the future, external imbalances within the Eurozone are less likely to

emerge. First, the EC will more closely monitor economic performance under the "Sixpack procedure" and may even impose fines if a country doesn't take corrective measures. Second, the Eurozone is endowed with the ESM as a new institution which provides bridge financing of countries experiencing funding problems where each financing round is conditional on achieving milestones of economic reform, and further funding may be denied at any time if a country doesn't comply. Accepting an ESM program imposes drastic reform *ex post*. Since an adjustment program implies a considerable loss of national sovereignty, its mere existence should improve incentives in advance to avoid that problems emerge in the first place. Finally, capital market discipline in terms of country specific risk premiums should prevent over- and underinvestment in different regions which might lead to wage increases not backed up by lasting productivity gains and thereby undermine competitiveness. It is critical that member countries are indeed able to reform labor markets and wage setting institutions. To effectively replace external exchange rate realignments, wage and employment flexibility must be high enough to assure competitiveness. Wage and income levels can only catch up, if a country invests in education, innovation, infrastructure and institutional quality.

Sustainable Public Finances and Sovereign Debt

With few exceptions, member countries of the Eurozone have accumulated government debt far in excess of the Maastricht benchmark of 60% of GDP. With differences across countries, excess public debt in Europe is partly due insufficient fiscal discipline but also due to the costs of fiscal stabilization and bank re-capitalization after the start of the economic and financial crisis in 2008. Many countries entered the financial crisis already with too much debt so that the urgent need for new spending led to liquidity problems and, in the case of Greece, to outright insolvency. Member countries have lost their fiscal leeway to digest further shocks. They will need a long time period to cut back debt to safer levels and, in this period, will largely be unable to use fiscal policy for active stabilization with tax cuts or discretionary spending. High debt also involves large scale redistribution at the expense of future generations. One may argue that financing the one-time costs of

stabilizing the financial sector with new debt reflects a fair burden sharing among present and future generations. However, such burden sharing requires that debt is low at the outset so that governments do not run into funding problems.

The current crisis demonstrates that a currency union makes government debt more prone to speculative attacks and, thus, more risky! The ECB is not allowed to directly finance government debt. Member countries have given up monetary autonomy. Hence, a member country cannot individually guarantee repayment of its debt since there is no national lender of last resort. Since the start of the financial crisis, some countries were confronted with high risk premiums. Given their competitiveness problems and weak growth prospects, investors started to doubt their ability to repay. If a country loses investor confidence, markets get unstable very fast. Trying to avoid losses, investors rush to sell out before bonds lose their value. When capital flight sets in, the value of bonds rapidly declines and interest rates jump up. Banks and other investors who wait too long see large losses on their bond holdings. Capital flees to safe havens with AAA ratings where interest rates are pressed to artificially low levels. In such a situation, investors tend to be very uncertain and overly risk-averse which further aggravates the crisis and may lead to risk premiums that far exceed economically reasonable values.

Whether a country suffers from temporary liquidity problems or is effectively bankrupt, is difficult to assess. Greece was insolvent since it possibly could not stabilize its fiscal budget without debt relief, even if interest rates were low. It was denied access to capital markets and could not refinance existing debt without international support. A haircut was unavoidable. Countries such as Spain and Italy, however, are still able to fulfill debt obligations as long as interest rates remain low. When investors are afraid to lose money, doubts about a country's creditworthiness can easily become a self-fulfilling prophecy. When investors lose confidence and have no other guarantee to be repaid in full, they must ask for higher interest to compensate the default risk. If a country is highly indebted, interest spending explodes when old debt must be continuously refinanced with higher interest. Full repayment becomes virtually impossible since the required taxes increase and spen-

ding cuts would be simply too large. What started as a temporary liquidity problem can turn into insolvency when investors lose confidence. An insolvent country cannot be stabilized without a haircut. Extending further credit would only postpone default, pile up even more debt and therefore increase the magnitude of the haircut. Once insolvency is recognized, the haircut should be immediate. The possibility of a haircut is also a precondition for effective market discipline whereby the default risk is priced in adequate risk-adjusted interest rates so that weak countries are discouraged to raise even more debt. The only question is – given the country's growth prospects, maximum tax capacity and minimum acceptable spending levels – how large the haircut should be so that remaining debt is safely repaid. Reform of the Eurozone must prevent, however, that a loss in investor confidence leads to exaggerated risk-aversion and pushes other countries with liquidity problems into insolvency. Countries may be trapped in a bad equilibrium where pessimistic investors ask for high risk premiums, pushing interest rates to unsustainable levels.

Avoiding speculative attacks on government bonds requires two contributions. First of all, a vulnerable country must implement radical reform. Budget consolidation must be so large that debt reduction becomes credible and debt is expected to fall to lower sustainable levels with reasonable speed. At the same time, fiscal and economic reform must promote growth to strengthen the country's debt capacity. High growth boosts tax revenue, reduces social spending and thereby raises debt capacity. Economic reform must stabilize the banking sector to prevent a credit squeeze, raise labor market flexibility to facilitate structural change, and insist on a strictly productivity oriented wage policy to reduce unit labor costs and strengthen international competitiveness. Second, the members of the Eurozone must establish institutions that offer investors a guarantee that debt will be repaid. The guarantee should prevent an exaggerated increase in interest rates and eliminate a bad equilibrium driven by pessimistic investor expectations. Risk premiums are not to be eliminated in full but should be limited to levels in line with economic fundamentals. To ensure capital market discipline, highly indebted countries with larger risk must pay higher interest while fiscally prudent countries with triple AAA ratings must be rewarded with lower interest. Investor confidence can be regained with several alternatives. One possibility is refinancing debt with Eurobonds or bringing all debt in excess of 60% of GDP into a debt redemp-

tion fund as proposed by the German council of economic advisors (GCEA). In both cases, government debt would be jointly guaranteed. Interest rates would reflect the average creditworthiness in the Eurozone. They would be higher for fiscally strong and lower for weak countries, leading to cross country redistribution. Lower interest rates would help fiscal consolidation in crisis countries but would also make consolidation less urgent and encourage moral hazard, leading possibly to further delays in consolidation and economic reform. Eurobonds and equivalent alternatives would effectively eliminate market discipline with differentiated interest rates. To substitute for market discipline, the GCEA suggests monitoring, control and sanctions.

Eurozone strategy to overcome the debt crisis rests on the ESM rescue fund and the ECB's announced guarantee in the form of OMT (outright monetary transactions). The ESM works much the same way as the IMF. The ESM is endowed with equity capital and further guarantees of member states to secure a top rating, allowing it to raise capital at very low interest. The key purpose is to extend staged credit financing with low interest but subject to strict conditions for fiscal and economic reform when a country in crisis has no longer access to the capital market. Further financing rounds are conditional on the fulfillment of key reform steps. These conditions enforce painful reforms for structural change and growth to raise a country's ability to repay credit in full. Making credit conditional on reform steps distinguishes ESM financing from normal bank credit and allows the ESM to extend credit even when private banks are no longer willing to do so. The IMF is allowed to give credit only when a country is illiquid but still solvent. If a country is insolvent, old creditors must agree to a sufficiently large haircut before the IMF lends new money. The same principles should apply to the ESM.

If the agreed reform steps are not fulfilled, further financing may be stopped, leading to bankruptcy and a complete shut-off from the capital market. The country might possibly exit from the Eurozone and devalue to regain international competitiveness much faster. It would regain full monetary sovereignty. Without access to international markets, it might be forced to monetize debt to keep up credit to banks and the government, possibly leading to large inflation. Devaluation of the national currency and inflation are drastic ways to eliminate high debt when other possibilities are no longer available.

The OMT guarantee reflects the ECB's readiness to buy government bonds on

secondary markets in potentially unlimited amounts to prevent a speculative rise in the interest rate that is no longer justified by economic fundamentals. This policy implicitly defines an upper limit on interest but still allows differential rates across countries that reflect default risks. Essentially, the policy announcement eliminated a bad equilibrium with pessimistic, self-fulfilling investor expectations. In the best case, the ECB guarantee is credible so that the OMT program need not be activated at all. In any case, the potential intervention of the ECB is conditional on the country applying for ESM financing subject to a rigorous adjustment program.³ A successful program reestablishes debt capacity and access to markets, allowing the ECB a credible exit from its policy and thereby avoiding inflationary risks of continued central bank financing of government debt.

Since the Euro has fostered capital market integration with much larger cross country borrowing and investment, it has also contributed to higher risk of contagion. Sovereign bonds of one country are held in many other countries of the Eurozone. In 2012, roughly 30% of Spanish bonds were held in France. The decline in Greek or Spanish bond values therefore destroys asset values in French and German banks and puts them at risk. Apart from that, investors may fear that a country in trouble could exit the Eurozone, with all contracts converted into national currency. The prospect of large losses due to subsequent devaluation can trigger massive capital flight. By eliminating speculative valuations, the OMT guarantee prevents capital flight and contagion of other countries.

Public should be lower for a Eurozone country than for an independent country since it is more prone to speculative attacks and therefore more risky in a currency union. Countries must thus cut down deficits and reduce excessive debt with acceptable speed to safe levels below 60% of GDP. The rules of the fiscal compact commit to reduce debt to safe levels. They must prevent that excessive spending of one member country leads to unsustainable debt and eventually to sovereign default with large losses not only to domestic creditors but in other countries as well. Inevitably, discretionary fiscal po-

3 Past ECB programs to purchase debt were unconditional and have shifted default risk from private investors and banks to European institutions and tax payers although a transactions price below face value already imposes a final loss on the private sector.

policy is not available to dampen economic cycles during the transitional period, apart from limited operation of automatic stabilizers. Low debt is not only required to prevent negative spillovers to other member countries, but should also be in the national interest for at least three reasons: low debt assures low interest spending; it reduces the fiscal burden on future generations; and it allows effective automatic stabilization and assures fiscal flexibility to finance sudden spending needs in a crisis.

An important question is how fast debt should be reduced and whether consolidation can be done in a way that keeps the growth prospects of the economy intact. A too fast speed augments the risk of a deeper recession that reduces tax revenue, inflates social spending and may end up being counterproductive. Given today's deep recession and expecting growth thereafter, it may be worthwhile to delay debt reduction by two to three years. However, in piling up more debt, a country must push through even larger fiscal consolidation in the future. Since highly indebted countries have limited access to capital markets, slowing down consolidation requires additional ESM credits that must be guaranteed by other member countries. To assure repayment of these additional credits, the country must legislate already today larger spending cuts and tax increases with full effect in two or three years.

In two or three decades ahead, sovereign default will be much less likely. Current reform in the Eurozone implements rules and safeguards that should enhance fiscal sustainability and avoid default risks *ex ante*. Should a country neglect fiscal prudence and end up with unsustainable debt, there is a larger chance of correcting the problem *ex post* and sovereign default will be much less chaotic and less contagious than today. These achievements rest on four pillars: (i) the fiscal compact prevents excessive debt *ex ante*; (ii) the ESM lends to illiquid countries subject to an adjustment program which pushes through savings and growth enhancing reform to strengthen debt capacity; (iii) the ECB's conditional OMT guarantee prevents speculative attacks that could drive still solvent countries into default; and (iv) credit to weak and highly indebted countries is subject to stronger market discipline in terms of risk-premiums.

Stable Banks and Efficient Capital Markets

Deteriorating growth prospects due to competitiveness problems, rising interest rates due to newly perceived credit risk in the South, and a correction of real estate prices have substantially raised the share of non-performing loans. Liquidity problems of crisis countries led to sudden increases in risk premiums and declining prices of sovereign bonds, thereby necessitating high write-offs on outstanding government debt. The large losses in bond values have substantially eroded equity ratios and made refinancing of banks more difficult. Low equity ratios of European banks make them particularly vulnerable. Doubts about the liquidity and mutual distrust freeze interbank markets, preventing banks to take loans from each other. They prefer to refinance with their national banks at the more lenient collateral requirements of the ECB.

Given the current state of affairs, banks can use national bonds as collateral for refinancing operations where the ECB accepts these bonds from all member countries without differentiation. Greek and Spanish bonds are as good as German and Austrian. In addition, banks do not need to hold more equity if they buy risky national bonds since they count with risk weights and are treated as perfectly safe when calculating equity requirements. Banks in crisis countries thus hold a much larger share of national bonds in their portfolio than would be wise from a diversification perspective, and face severe problems when these bonds loose value. An illiquid government thereby triggers or exacerbates a banking crisis. A banking crisis, on the other hand, is often due to other reasons such as rising private insolvency rates after a deep recession or a bursting real estate bubble. The need to support systemically important banks in order to prevent a credit squeeze can lead to a sudden rise in sovereign debt. A higher risk of sovereign default jacks up interest rates and depreciates bond values which feeds back on banks. Banking and sovereign debt crises create a vicious circle which is more destructive when (i) governments are highly indebted, (ii) equity ratios and crisis resilience of banks are low, and (iii) banks hold a large share of local government bonds.

A European Safe Asset

The stability of the financial sector hinges on the safety of banks but also on markets including markets for sovereign bonds. Regarding asset markets, the financial architecture in Europe suffers from two problems (see Brunnermeier et al., 2011, and Beck et al., 2011). First, the absence of a European wide safe asset induces capital flight from risky to safe countries in times of crisis. Second, government bonds have zero risk weight in calculating minimum equity ratios so that banks do not need to raise equity when they hold more risky sovereign bonds. Safe assets are a central part of any investment portfolio. Sovereign bonds emitted by Germany and a few other stable countries are simply not enough to satisfy investor demand. The flight to safety in times of crisis wipes out demand for risky bonds of crisis countries and creates excess demand for safe bonds such as German or Austrian ones. Such investor behavior results in mispricing of sovereign bonds and severe distortions to capital allocation, leading to artificially low interest and unhealthy overinvestment in safe countries and excessively high interest and underinvestment in risky countries. The ECB suffers from the regulatory failure and the absence of European wide safe bonds since it has to accept ever weaker assets as collateral to allow refinancing of banks in crisis countries. If it accepted only bonds from safe countries, it would exacerbate capital flight from crisis countries. In turn, by accepting low quality assets as collateral, it allows banks in crisis countries to hold bonds of their own governments and thereby reinforces the vicious loop between sovereign and banking risk.

The proposal by Brunnermeier et al. (2011) and Beck et al. (2011) offers a solution with three parts: (i) in addition to national government bonds, introduce a large amount of European Safe Bonds (ESBies) based on a widely diversified portfolio of Eurozone sovereign bonds; (ii) assign correct risk weights to national government bonds; and (iii) allow the ECB to accept only ESBies as collateral for open market operations. ESBies would be offered by a European Debt Agency (EDA) which would buy national sovereign bonds and build a widely diversified portfolio with fixed portfolio shares that correspond to each country's share in total Eurozone GDP. Using its bond holdings as collateral, EDA would issue senior claims (ESBies) and junior claims on its portfolio earnings (tranching). For example, ESBies could make up 70% of the underlying

collateral value and, being senior, would be served first. Junior claims would bear residual earnings risk if the portfolio performs poorly. Much like equity shares which get paid only after debt is repaid, the junior tranche would be a risky asset offering much higher return in good times and taking losses in bad times. With the right risk-return trade-off, there would clearly be demand for junior bonds. The tranching makes ESBies much safer than diversification alone since it shifts risk from senior to junior bonds. Although this being not an essential feature, ESBies could be made even safer if EDA – like the ESM – were endowed with public guarantees or paid in equity capital. In combining diversification, tranching and, possibly, public guarantees, ESBies could easily be made safer than even German sovereign bonds. Since EDA would buy only part of a country's sovereign debt, each country would have to issue national bonds at the margin which would be separately valued by investors according to their default probability. In turn, national bonds should receive the correct risk weights in the Basel equity standards for banks. Finally, the ECB should no longer accept national bonds as collateral for its open market operations but only ESBies as truly safe assets.

Creating a European wide safe asset together with the regulatory changes would have several key advantages. First, it would prevent large scale capital flight and price distortions in the Eurozone, leading to excessive risk premiums on sovereign bonds of crisis countries. The flight to quality would lead investors to trade junior bonds for ESBies, instead of moving capital from crisis countries to safe havens in the North. Second, banks would no longer be induced to hold too much risky government debt of their home country but would rather acquire ESBies. They would be better insured against the risk of home country sovereign default. Third, governments could place part of their debt with EDA. They would face stronger market discipline since marginal debt would need to be raised on capital markets where it gets correctly priced according to the default risk. Fourth, the ECB would finally be able to insist on truly safe assets – ESBies – as collateral for open market operations. The ECB could thus avoid taking on large risks on its balance sheets. Banks would hold ESBies and offer them as collateral instead of risky local government debt. In contrast to Eurobonds, ESBies avoid the potential large scale redistribution across Eurozone countries. There is no liability of European tax payers. Sovereign default risk after diversification is entirely shifted onto the holders of

junior bonds and of marginal national bonds, who must be compensated for risk bearing with a higher interest including a risk premium.

More Equity for Banks

Apart from liquid capital markets with a full range of risky and safe assets, financing growth in Europe critically depends on availability of bank credit for private investment. A healthy banking sector is, thus, a key precondition for new growth. Banks must fulfill their productive role with adequate risks. Essentially, the banking sector must fulfill three tasks: (i) risk diversification by investing savings deposits in a broad credit portfolio for businesses and private households; (ii) term transformation by investing short-term deposits in long-term credit to fund investment in equipment and buildings; (iii) capital allocation towards investments which earn the highest returns with adequate risk, and denying credit when default risk is too high and collateral is insufficient. Uncompetitive firms and households with uncertain income perspectives have little capacity to bear debt, are likely to default, and should be denied credit. To assure these growth enhancing functions, regulation of banks must be improved so that profit driven banks take account of all economic costs of financial intermediation and serve to promote economic welfare. A central problem in the Eurozone is the low capacity for shock absorption and the high systemic risk due to mutual lending on the interbank market. If a large bank invests too risky and then becomes insolvent since it has not enough equity capital to absorb losses in a crisis, it cannot repay credit taken from other banks. If these banks also have too little equity, they may be unable to withstand the credit loss and may become insolvent as well. The insolvency of one bank can develop into a systemic crisis and may severely interrupt the supply of credit to the real economy. Under these circumstances, governments have little choice to bail out systemically important banks and inject capital taken from taxpayer money. If a bank recovers, it will be able to repay credit without any net burden on tax payers. If it is not profitable, a new credit will only postpone insolvency and leave tax payers to bear the losses. Subsidizing unprofitable banks is not only costly but also distorts competition as these banks steal business from profitable banks and impair their growth potential and financial robustness. If profits remain private but losses are shifted to

taxpayers, banks will choose more risky investment strategies, promising high profits in good times but also causing large losses if chances turn out unfavorable. Spain, Ireland and Cyprus are examples. Preventing such moral hazard requires market discipline where unprofitable banks are closed down instead of being artificially kept alive.

To strengthen the crisis resilience of banks, a higher share of credit and other assets must be propped up with shock absorbing equity. The equity share must be larger for banks that follow riskier investment strategies. A bank that predominantly lends to small and medium sized businesses needs less equity capital than a large bank with own trading, international credit to large companies and high systemic relevance. These regulations are part of Basel III reforms and must be a central part of the solution of the Eurozone crisis. Higher shares of equity or similar financial instruments such as convertible debt not only reduce the systemic risk within a country but also reduce the risk of contagion of other countries in the Eurozone.

Higher equity ratios of banks are an indispensable part of the crisis resolution. Banks can raise equity capital without restraining credit supply by retaining earnings or issuing new equity capital on the market. Alternatively, they may extend less credit, reducing their need for new deposits or higher interbank and central bank funding which also raises the share of equity in total assets. Restraining credit supply reinforces the recession and impairs growth. However, credit demand also declines on account of reduced debt capacity of the private sector, reflecting little own equity of firms and households, low quality of collateral and unfavorable earnings prospects due to lost competitiveness. Recapitalization of banks could also reduce investment by raising loan rates of interest if equity is more expensive than bank debt. On the other hand, more equity reduces risk, making investors ask for a lower risk-premium and supply cheaper equity capital. Maybe the most important asset is investor confidence in the safety and crisis resilience of a bank which reduces the required return on equity.

The higher liquidity and equity requirements according to Basel III and the compliance costs with regard to new regulations may potentially lead to a moderate rise in loan rates. This would be the price to pay for more safety

and crisis resilience. With more equity, banks and their investors can digest potential losses more frequently and at a larger scale, without recurring to tax payers. However, some market participant must bear the losses: either households or firms pay higher loan rates, or savers receive lower interest on deposits, or owners receive a lower return on equity. Either loan demand, or savings deposits or the supply of equity capital are expected to decline. In all cases, credit financed investment is negatively affected. Nevertheless, this 'privatization of losses' is desirable since interest rates should correctly include all economic costs of financial intermediation. Once recapitalization is achieved and banks are more robust, credit supply will be more stable and growth less risky. Recapitalization of banks is a precondition for sustainable growth. In addition to higher equity ratios on average, they should also be less pro-cyclical than in Basel II in order to dampen economic fluctuations.⁴ Higher equity requirements in boom periods restrict credit supply and prevent overheating of the economy while more lenient standards in a recession would facilitate credit supply when it is most needed.

Banking Union

The Euro contributed to the development of a large common capital market. As a consequence, cross border banking has expanded. For example, in 2012, around 40% of the assets of Austrian banks are invested in other European countries. Regulation of banks in one country thus tends to affect subsidiary branches in other countries as well. For example, tougher equity and liquidity requirements in Austria raised concerns about Austrian banks cutting back lending in Eastern Europe. Furthermore, countries compete for a larger share of the financial industry as a source of employment, income and tax revenue. To avoid losing business to other locations, authorities might have an incentive to favor national financial development and become too lenient on national champions. Such behavior might harm financial stability in all of

4 In a recession, default rates and credit risk are high, requiring banks to maintain more equity which restricts lending and exacerbates the recession. The opposite happens in boom periods. This pro-cyclicality in Basel II regulations can be reduced by applying average default rates, leading to smoother equity requirements over the cycle, or by requiring banks to maintain counter-cyclical capital buffers.

Europe. Finally, small countries might simply lack the financial capacity to shoulder the costs of re-capitalizing or winding down large European banks. The strategic incentives in the international competition for a large share of the financial industry and the cross border effects of national supervision are strong reasons to form a European banking union.

The Eurozone needs procedures for a controlled resolution of unprofitable banks with cross-border activities that does not endanger financial sector stability. Apart from higher equity standards, the possibility of controlled defaults should lead banks to adopt less risky strategies and is a precondition for tighter market discipline. A common procedure for the resolution of unprofitable banks must allow the continuation of profitable parts and protect the systemic functions relating to the payments system, e.g. by selling to other banks. If a bank is fundamentally profitable but faces temporary liquidity problems and finds it impossible to refinance on the interbank market or with other sources, it should be recapitalized. The dividing line between insolvency and illiquidity is often blurred. If credit is given to a profitable bank with liquidity problems, the credit will be repaid. If a bank is insolvent, it should be immediately forced into a controlled resolution procedure. Further capital injections would be largely lost. They would only postpone the insolvency to a later date.

The design of a banking union must clarify the organization of three responsibilities, i.e., supervision of banks, resolution and recapitalization, and deposit insurance (see contributions in Beck, 2012, and CESifo, 2012). Given that depositors are insured (up to 100.000 Euro) and have neither an incentive nor the competence to monitor banks, supervision must be organized on behalf of depositors. Since the functions of a banking union are strongly interdependent, they should be tightly coordinated or responsibility should be concentrated in one institution. For example, centralizing supervision in the ECB and leaving bank recapitalization and resolution to member states is likely to create severe conflict. When the central supervisor overlooks emerging problems, national governments would have to pay for bank recapitalization or resolution. To internalize the costs of forbearance, the responsibility must be in one hand. Given cross-country spillovers and systemic risk to financial stability of the Euro area, it should be centralized in a separate unit of the ECB or, even better, in a truly independent agency.

To handle bank recapitalization and resolution, the new authority needs substantial resources. When a large part of a bank's assets must be written off, the losses could easily wipe out equity capital and exceed the possibilities of bailing in large creditors and bond holders or even unprotected large depositors. There must be a clear order in allocating financial losses when a bank becomes insolvent or illiquid. First, owners claim all profits in good times and must pay for losses until equity is used up. Second, bondholders and creditors are compensated for risk-bearing with higher interest on loans and must be bailed in when equity is used up, e.g., by forcing to convert bonds or loans into equity. Third, large unsecured deposits in excess of the deposit insurance guarantee should similarly be converted into equity. Conversion boils down to a haircut but allows creditors and depositors to share in the upside potential if the bank recovers. Only in extreme events when all other sources are exhausted, should the tax payer step in. Public capital injection should be in exchange of equity shares, to allow tax payers to share in the bank's upside potential. In a severe crisis, the costs to tax payers of bailing out illiquid banks or the costs of a controlled resolution of insolvent banks is still much smaller than the costs of chaotic bankruptcy. Such an event could lead to a collapse of the financial system, resulting in a severe credit squeeze and a deep recession. A controlled resolution of banks must transfer systemic functions and sell off profitable parts to other banks. Non-performing loans and other toxic assets must be written off to a large extent, transferred into a temporary bad bank and sold off separately.

A banking union requires resources to perform its three functions which should be prefunded. Building up a large deposit insurance and resolution fund could be linked to current deposit insurance schemes with premium payments of banks appropriately adjusted and scaled. The system should be in two layers, and contributions would have to be split accordingly. A first national layer would cover insurance payments to national depositors and resolution of local banks. A second European layer would be activated in the rare event of a systemic crisis when national funds are exhausted, and would deal with systemically important, European wide banks. The second layer leads to additional diversification across countries and much reduces the chances of capital and deposit flight when national deposit insurance is expected to be insufficient in a severe crisis. The ESM would serve as an additional fiscal

backstop with possible direct lending to large banks if insurance funds are exhausted in a truly large crisis. The final lender of last resort is the ECB with ELA credits to banks (Emergency Liquidity Assistance).

Insurance always holds the potential for cross-subsidization and excessive risk-taking when insurance premiums are not actuarially fair ex ante. Deposit insurance premiums must be tightly linked to operational banking risks. They should differ across banks within a country and across countries. Banks with riskier activities and less equity capital must pay higher insurance premiums than banks with safer activities. Banks in member states with systematically higher credit and deposit risk should also pay larger premiums than banks in very safe countries. A violation of these principles would distort risk-taking in banking and lead to redistribution across countries and banks.

How to share the costs of re-capitalizing profitable banks and winding down structurally unprofitable ones together with deposit insurance payments must be decided before a country joins the banking union. The legacy costs of past aberrations are a separate problem that should be handled by home countries, and if unable, by temporary lending via the ESM. Special taxes on banks are often motivated by the need for the banking sector to pay for the costs of the financial crisis. A problem with this argument is that prudent banks would end up paying for the failure of hazardous competitors. Special taxes on the financial sector should be designed to correct incentives and reduce excessive risk-taking ex ante. Special financial sector taxes must also be judged in the context of the whole tax system. Banks are exempt from value added tax (VAT) but are subject to normal corporate income tax (CIT). The CIT, by the way, favors excessive leverage since interest on debt is deductible while the opportunity cost of equity is not. Bank generated capital income is further subject to personal taxes of shareholders. The existence of externalities – the ‘too big to fail’ guarantee is an implicit subsidy – justifies some corrective taxes such as financial activities tax and bank levies (‘Bankenabgabe’).⁵ The case for additional corrective taxes vanishes, however, if the market failure is already cured by regulatory measures and risk-based

5 The case for a financial transactions tax is doubtful since it is not even clear whether it can reduce the volatility of financial transactions which is the main purpose of the tax.

deposit insurance premiums. An excessive cumulative burden of financial sector taxes will backfire since they inflate the cost of credit to firms and households, diminish retained earnings which banks need to save for higher equity capital, and could thereby undermine the stability of banks. Credit and banking services are an important intermediate input to the business sector. Making them more expensive depresses growth.

Finally, Eurobonds with joint liability in various forms seem redundant since the potential advantages are already realized by other measures. First, Eurobonds promise lower interest for highly indebted, illiquid countries, but the ESM already supplies credit at a very low interest subject to strict conditions. Second, the fiscal compact already implements tight monitoring and control as suggested by the proponents of Eurobonds. Third, introducing European safe assets (ESBies) and completing a banking union are better ways of preventing capital flight and, thereby, excessive interest in crisis countries, without holding other countries liable via joint guarantees.

In the future, improved regulation of banks and capital markets will provide for more stable and efficient financial intermediation, break the vicious loop between banks and sovereigns, and support the growth enhancing role of a large and liquid common capital market. First, larger equity ratios make banks more robust so that they will be able to digest larger losses in times of crisis without the need for public recapitalization at tax payer's cost. Second, asset markets will be complete with a European wide safe asset, based on a diversified portfolio of sovereign bonds. This will prevent speculative capital flows in the Eurozone. Flight to quality will be from junior risk bonds to senior safe bonds, rather than from risky to safe countries leading to distorted interest rates. Third, bank regulation will prescribe risk-adjusted equity ratios that assign positive risk weights on risky sovereign bonds. Banks will prefer to hold more safe bonds (ESBies) and less national bonds, making them less exposed to home country default risk. Fourth, a banking union will establish a procedure for a controlled resolution of unprofitable banks, bailing in equity, loans and large deposits before resorting to tax payers. Deposit insurance will be national by default and include a central insurance mechanism only when national resources are exhausted. Finally, taxation of the financial sector will be on fair terms relative to other sectors where specific taxes are

clearly designed and limited to internalize external social costs of financial activity if they are not already addressed by regulatory changes. Too many taxes create an excess cost of financial intermediation, making credit and financial services too expensive and retarding growth.

Conclusions

This essay promotes the vision of Europe as a union of sovereign countries which subscribe to the subsidiarity principle. Decision making is decentralized by default but countries cede autonomy to central authorities in areas of joint interest. This vision rests on three pillars. First, the diversity and cultural heterogeneity of Europe call for a decentralized approach which keeps public decision making close to citizens. We believe that decentralization renders politicians more accountable to the concerned electorate and makes public decisions democratically more legitimate. Second, countries willingly give up autonomy and national sovereignty in areas of joint interest where centralization yields better results for all than each individual country could achieve in isolation, i.e., where Europe is more than the sum of its parts. The common market program, the introduction of one money, and central surveillance and resolution of cross-border banks are examples. Third, Eurozone countries must accept that income levels can widely differ, depending on education and training, innovation, productivity increasing investment and a country's institutional quality. The Euro is not a free lunch for fast catch-up growth. Redistribution and solidarity in Europe should be explicit and transparent with better targeted regional policies of the EU rather than with hidden cross-subsidization and ill designed joint liability. It should be voluntarily decided ex ante by explicit decision making instead of being dictated ex post by the need to prevent an uncontrolled unraveling of the Eurozone. Fourth, ensuring good outcomes of central decision making requires clear rules and joint institutions that will put an end to 'beggar thy neighbor' attitudes. Such moral hazard is neither compatible with economic sustainability nor with political harmony. Rules and institutions must aim to internalize negative cross-border externalities in national decision making so that forming a monetary and economic union leads to greater net benefits for all members.

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Reducing Divergences in the Eurozone

Maria João Rodrigues

The Eurozone crisis is not only sum of national crisis but also a systemic crisis of the Economic and Monetary Union (EMU). In spite of the recent transformation of the EU economic governance, there are still many problems and the Eurozone crisis is moving to a new stage. More comprehensive plans to complete the EMU are being discussed, but they will not be effective if there is not a clearer analysis of the economic and social divergences which are undermining it. In order to reduce these divergences, we need more coordination of the national policies, to be supported by stronger instruments at European level, including some kind of a Eurozone fiscal capacity. These policy developments can only take place if they are underpinned by a new Deal with new rights and duties for Member States and citizens.

These are the main thesis of this paper, which are based on many other discussions and research projects taking place across Europe.

1. Two different narratives on the Eurozone Crisis

Furthermore, there are currently two very different narratives about the ongoing Eurozone crisis: a crisis in the euro-zone or a crisis of the euro-zone.

According to the first version, the main problem has to do with the lack of fiscal discipline in some peripheral countries which led to unsustainable public debts damaging the credibility of the euro. Hence, the logic solution should be to strengthen fiscal discipline and to impose austerity even at the cost of recession in these countries.

According to the second version, the need to strengthen fiscal responsibility is also accepted, but a more comprehensive diagnosis is proposed. Some fiscal and macro-imbalances were already at work before the financial crisis, but they were worsened by this crisis which led to a deep recession and high unemploy-

ment. Special public stimulus packages were necessary to avoid depression and to rescue failing banks, but they increased public deficits and debts. This shock has hit the euro-zone as a whole, but the recovery process became more difficult for the Member States with less fiscal space and/or less reliance on exports to outside Europe.

In this second version about what is happening, there are three reasons to consider that we are in face of a systemic crisis of the euro-zone:

- first, while some differences in the spreads across Member States can be accepted as normal, the current wide divergences are worrying because they are also turning into divergences of their investment conditions, their growth and employment rates as well as their public deficits and debts;
- These cumulative divergences are magnified by the interaction between sovereign debts and banks debts and the contagion risks. This has led to a fragmentation of the European banking system hindering the normal circulation of capital and the access to credit in the Eurozone.
- Behind these major disturbances, it is possible to identify some important flaws in the architecture of the Economic and Monetary Union. That is why a comparison with the available experience of monetary zones can also be relevant.

2. The Transformation of the EU Economic Governance

We cannot say that nothing was done to address these problems. On the contrary, over three years of intensive political creativity, a new framework for the EU economic governance was developed to address key problems of the EMU. This new framework can be summed up as follows:

Regarding fiscal discipline (with new legislation to reform the Stability and Growth Pact and the new Inter-governmental Treaty on Stability, Coordination and Governance):

- a commitment to balanced budgets;
- a new focus on public debt and not only deficits;
- a reference to the structural deficit complementing the usual reference to the nominal deficit

- more automatic and tougher sanctions;
- closer monitoring of the Member States under financial assistance;
- many new commitments to structural reforms and spending cuts were made by the Member States.

Regarding financial stability:

- new regulations for financial systems concerning capital requirements, hedge and equity funds, some derivatives and bonuses;
- new European supervisory bodies and regular stress tests on banks;
- instruments to respond to sovereign debt crisis (EFSF and ESM);
- new roles for the ECB.

Regarding Growth (Europe 2020 Strategy):

- a long-term strategic commitment for smarter, greener and inclusive growth;
- European flagship initiatives;
- national reform programmes;
- an Annual Growth Survey and recommendations for the Member States.

Regarding macroeconomic imbalances (with new legislation):

A new process of macroeconomic surveillance to monitor major problems of external and internal economic and social imbalances, with a more symmetrical approach.

Regarding Governance (with legislation and a new Treaty):

- reorganisation of the annual cycle to prepare national budgets and national reform programmes with ex-ante European coordination, meaning more shared sovereignty (European Semester);
- regular Eurozone summits with a permanent President and leading team, including the President of the European Commission and the President of the Eurogroup; a inclusive approach regarding the Member States willing to join;
- involvement of the national parliaments and the European Parliament in the discussion of Eurozone issues;
- more systematic coordination of the EU with its international partners (the IMF and the G20).

3. ...but still many problems

Despite these important policy developments, the Eurozone crisis is still going on. The problems include:

- unsustainable debt levels in some countries;
- diverging levels of borrowing costs between countries;
- diverging growth trends, in several instances negative;
- a general trend towards recession and rising unemployment;
- increasing spillover effects for the global economy: the Eurozone crisis has become a global problem;
- political opposition to further European solidarity in some Member States;
- political opposition to more structural reforms, taxes and spending cuts in other Member States;
- a widespread sense of a loss of democratic control over general living conditions. Europe is now perceived by many as strongly shaping their lives, but not susceptible to democratic influence at national level.

In fact, these problems are now so deep and central in many Member States that the exit from this crisis can shape the future not only of the EMU, but also of European integration and Europe's position and role in the world.

4. A New Stage in the Eurozone Crisis

More recently, the Eurozone crisis is moving to a new stage.

The EMU has been equipped with new crisis management instruments to deal with a sequence of national cases of bailout of States and/or banks avoiding rocketing spreads and bank collapses and preventing the risk of default or exit with unforeseeable consequences. EFSF/ESM and the ECB non-conventional instruments are learning how to perform this job. On the preventive side, more stringent fiscal discipline was codified by the reformed SGP (6 Pack and 2 Pack) and a new process of macroeconomic surveillance is underway. Nevertheless, the crisis is far from over and is showing the limits of this "muddling through" process.

This new stage of the Eurozone crisis has the following features:

- With financing costs still very different, the Eurozone Member States star-

ted diverging increasingly in investment rates, growth rates, job creation, unemployment and poverty rates;

- more recently, this cumulative trend is dragging the aggregate Eurozone and EU economy into an installed recession, chronic unemployment and deeper social inequalities in and between the Member States;
- these tensions are having clear implications in the political domain, with the strengthening of anti-European movements, weakening of the pro-European political parties, spreading Euro-skepticism and legitimacy crisis of democratic institutions at both European and national level;
- this is leading to a crisis of the European integration which is also having implications for the EU international status and role.

The virtuous combination between fiscal consolidation and growth has become impossible for several countries, whatever the efforts they might do, because they are dealing with unbearable conditions to finance both companies investment and public debt service.

In the most vulnerable countries, notably those exposed to the Troika programmes, a “jobs destruction machine” is underway leading to 50% of youth unemployment and 25% of general unemployment. This machine is being very effective in destroying many viable jobs and companies because their access to credit is disappearing while, at the same time, their internal demand is decreasing under the double effect of wage and social benefit cuts and of tax increases; this trend is too deep to be offset by the ongoing effective effort to increase exports. This has triggered a recessive spiral which undermines not only investment, growth, employment and social cohesion but also all efforts already made for fiscal consolidation. The ratio public debt /GDP is increasing in these countries showing why too harsh austerity policies are counterproductive even for the purpose of fiscal consolidation.

The scale of this divergences can only be stopped by stronger instruments at European level: ESM, ECB, partial mutualization to bring down the costs of debt issuance. More effective EIB and Banking Union to restore the normal access to credit. All this should be based on clear and balanced conditionality to prevent moral hazard and to re-launch sustainable growth

This Eurozone crisis appears now to be not only a sequence of national cases of financial disturbances, but also a systemic and multidimensional crisis which can only be overcome by a more systemic and comprehensive

solution aiming at overcoming major flaws and completing the architecture of the EMU.

It is against this background that a sequence of more fundamental reform proposals have come to the fore. Four basic frameworks have been under debate to complete the EMU: the financial, the economic and social, the budgetary and the political.

5. The Nature of the Current Divergences in the EMU

Nevertheless, the EMU reform process can only be effective if there is a clear distinction of different types of divergences to be addressed:

First type: **cyclical divergences** created by asymmetric shocks hitting particular regions or counties due to their pattern of productive specialization. This kind cyclical divergences of growth and employment will always exist due to a natural - and desirable - variety of productive specializations. In other monetary zones, these divergences are reduced by federal instruments for macro-economic stabilization. In the EMU, the national instruments with this purpose were reduced to a small room of manoeuvre in the budgetary policy and there are no instruments at European level. This means that if an Eurozone MS is hit by an asymmetric shock, there are few means to avoid the social impact in terms of wage and benefit cuts and job losses. Another source of cyclical divergences are the different national inflation rates affecting the real interest rate and price competitiveness; they can be notably be reduced by better coordination of wage bargaining against productivity gains across Member States.

Second type: **structural divergences** in the response to globalization and the need to move to a new growth model more knowledge-intensive and less carbon-intensive, adapting structures and preparing people to new jobs. This transition requires an important amount of new investments and of structural reforms - in business framework conditions, labour markets, social protection, education, innovation systems- which should be better coordinated at

European level, because they have many spill-over effects. So far, the divergences between the Eurozone MS have increased by lack of investment means and coordinated reforms. These structural divergences in competitiveness have led to macro-economic imbalances which were not identified and corrected in time.

Third type: the recent **financial divergences** leading to a credit crunch in some Member States and magnifying the macro-economic imbalances which were already building up in the Eurozone due to the cyclical and structural divergences already referred above. Moreover, the crisis of the Eurozone interconnecting high sovereign debt with high bank debt has created cumulative divergences between Member States regarding financing conditions, investment rate, growth rate, unemployment rate and sustainability of welfare systems. The instruments which were created so far- notably the European Stability Mechanism and the new ECB instruments - are able to reduce the divergences regarding the financial conditions, but not the other divergences regarding growth and the social indicators.

6. The Implications for the Social Dimension of the EMU

If these EMU flaws are not addressed, the most likely sequence of events will be:

- In the most vulnerable Eurozone countries: important reduction of wages, social benefits first; followed by important jobs losses triggering a recessive spiral; high unemployment and uncontrolled emigration
- In the other Eurozone countries, increasing pressure on their social standards; risks of social dumping
- In the EU as a whole, erosion of the existing instruments to provide a social dimension; reduction of the aggregate internal demand, shrinking the internal market; systemic pressure towards lower growth or recession

In order to reverse these trends, the EMU should be completed regarding its missing instruments in the financial, fiscal, and economic as well as its social dimension. It can certainly be useful to make full use of the previous social instruments already existing. But the current financial and economic pressu-

re is so high that they will be eroded if they are not complemented by some stronger instruments for a social dimension in the EMU.

7. Can Monetary Integration Work without Fiscal Integration ?

More fundamental research is also necessary to identify which are the basic conditions for a monetary zone to work and survive? A rich and long international experience tell us two basic conditions are required:

- sufficiently integrated markets and mobility of factors to facilitate a certain degree of convergence between the competitiveness of the Member States
- monetary integration must be coupled with a considerable degree of fiscal integration.

The current European debate recognises these two conditions but is divided about the importance to be given to the convergence objective as well as about the meaning to be given to fiscal integration:

- for some, this is just about defining and enforcing a common fiscal discipline;
- for others, this is also about coupling this common fiscal discipline with a common budget based on some common taxes and with better instruments to issue and manage public debt.

The available international experience shows that fiscal unions with shared currency have a basic set of similar features:

- common principles of fiscal discipline in the sub-central governments
- in this common framework, sub-central governments enjoy different degrees of fiscal autonomy to meet their financial obligations with their own fiscal resources
- a central government with a relevant budget based on own tax resources and a Treasury responsible to issue common debt.

The roles of this central government budget are usually the following:

- a macro-economic stabilisation and anti-cyclical function to protect re-

gions under asymmetric shock, whatever their relative level of wealth (richer or poorer regions);

- a mutualisation of risks if there is mutualisation of the decision-making, notably on issuing public debt
- a redistributive function, involving a transfer of resources from more competitive and wealthy regions to less competitive and wealthy ones. A VFI (vertical fiscal imbalance) between income and spending is accepted to enable this redistribution, provided free rider and moral hazard are prevented.

8. What Kind of Fiscal Capacity is needed in the EMU?

The fiscal union in the European Economic and Monetary Union has precise principles of a common fiscal discipline, but:

- its macro-economic stabilisation function remains very weak, because its instruments at national level are now reduced to very a tight fiscal room of manoeuvre and they are not complemented by instruments at European level
- it is silent about the need of a Eurozone budget and its possible roles. The discussion about equipping the euro-zone with some kind of “fiscal capacity” has just started.
- it is still incipient about the possible ways to mutualise risks and decision-making about debt issuance. The European Stability Mechanism is used to issue euro-bonds at small scale but the discussion of conditions to issue euro-bonds at larger scale is being postponed
- The EU Community budget plays a re-distributive role but only at a small scale.

In order to reduce dangerous internal divergences, the EMU should be equipped with a proper fiscal capacity able to cushion asymmetric shocks, whatever the Member State, and able to promote catching-up and structural convergence between Member States by focusing on capacity building. The financial resources of this fiscal capacity (preferably own resources) can provide a basis for borrowing via Eurobonds in order to finance European investments, complementing the national ones. This can become an embryo of European Treasury.

9. Redesigning the Instruments for a Sustainable EMU

The current new instruments were forged in extreme situations, where the choice was between a collective abyss and a patch-worked solidarity.

Now, that the risk of Eurozone break-up seems less dramatic but the crisis is far from over, it is time to consider a more systemic and Community approach for a crisis which is systemic.

Against the previous background, this approach can be logically developed according to the following steps and building on the existing instruments:

- a. All EU member states and therefore all Eurozone members should have the conditions to implement the EU strategy for a new and more sustainable growth model, greener, smarter and inclusive. This requires a particular combination of investments and reforms which should be coordinated at European level according to the new schedule defined by the so-called European semester. This means that the consistency of national policies with the European policies is to be checked at European level before final adoption by the national governments and parliaments. This should also be used to identify the kind of European support which should be provided to complement the national effort.
- b. The same should happen with the solutions to address the macro-economic imbalances, and which should combine national efforts with support by a Eurozone budget, in case of asymmetric shocks. On the top of this surveillance of national imbalances, a more general macro-economic coordination should take place in order to define the better policy-mix for the Eurozone as a whole.
- c. The fiscal coordination should supervise the national efforts for fiscal consolidation as well as identify the needs for complementary European support.
- d. The European support for investment and structural convergence should be provided by the EU Community budget via the Community programmes or the structural funds, to be aligned with the Europe 2020 Strategy.
- e. The European support for macro-economic stabilisation which is required to address specific problems of the Eurozone should be provided by a complementary Eurozone budget based on Eurozone taxes and borrowing in the markets via Eurobonds issuance.
- f. The European support via the Community budget or via the Euro-zone

- budget should be attached to a conditionality to be aligned with the EU priorities – assuming they are defined in a balanced way
- g. The European Stability Mechanism should focus its activity on a rescuing role regarding sovereigns. When requested by a euro-zone Member State, and under conditionality, it should also use its capacity of issuing euro-bonds to buy in the public debt primary markets.
 - h. The European Council, the Council, the European Commission and the European Parliament should organize themselves internally to deal with the euro-zone issues more effectively. The national parliaments should also be better involved insofar they frame the national governments positions at European level.

We also assume that the on-going process to build up a **banking union** with a single supervisory system, a bank resolution mechanism and an harmonised deposit guarantee will be completed soon, as this is a crucial pillar to overcome the euro-zone crisis. This means that all over this process, the ECB will build up a new role dealing more specifically the financial stability.

Of course, such a development of the Economic and Monetary Union should be based on a New Deal whereby Member States should accept:

- stronger European supervision on their banks, if a common bank resolution and deposit guarantee is built up
- stronger coordination of their economic and social policies and reforms, if a fiscal capacity is built up
- stronger sharing of sovereignty at European level, if the decisions are taken in more democratic terms.

The recently created Eurozone Summit should start dealing with these issues and be accountable in face of a stronger democratic role to be played by the European Parliament and national parliaments.

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Governance of EU coordination

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Governance changes in response to the crises

The problems in the EU and the euro area following the economic and financial crisis were quickly recognised and well addressed (at different rates) at the political level. The response at the European level resulted in a new set of rules on enhanced economic governance, which distinguish partly between euro area and non-euro area Member States (see Graph 1).

The Europe 2020 Strategy, the successor of the Lisbon Strategy 2010, aims at smart, sustainable and inclusive growth with broader coordination of national and European policy while respecting macroeconomic and fiscal constraints. These three mutually reinforcing priorities should help the EU and the Member States deliver high levels of employment, productivity and social cohesion. In order to achieve this goal, the Strategy identifies five headline targets the EU should meet until 2020:

1. Raising the employment rate of the population aged 20–64 to at least 75%.
2. Investing 3% of GDP in R&D in particular by improving the conditions for R&D investment by the private sector.
3. Reducing greenhouse gas emissions by at least 20% compared to 1990 levels or by even 30% if the conditions are right; increase the share of renewable energy in final energy consumption to 20%, and achieve a 20% increase in energy efficiency.
4. Cutting down the share of early school leavers to 10% from 15% and increase the share of the population aged 30–34 having completed tertiary education to at least 40%.

1 Based on Commission's and Council's press releases and communications as well as legal text. Many thanks to Peter Part and Barbara Posch for helpful comments.

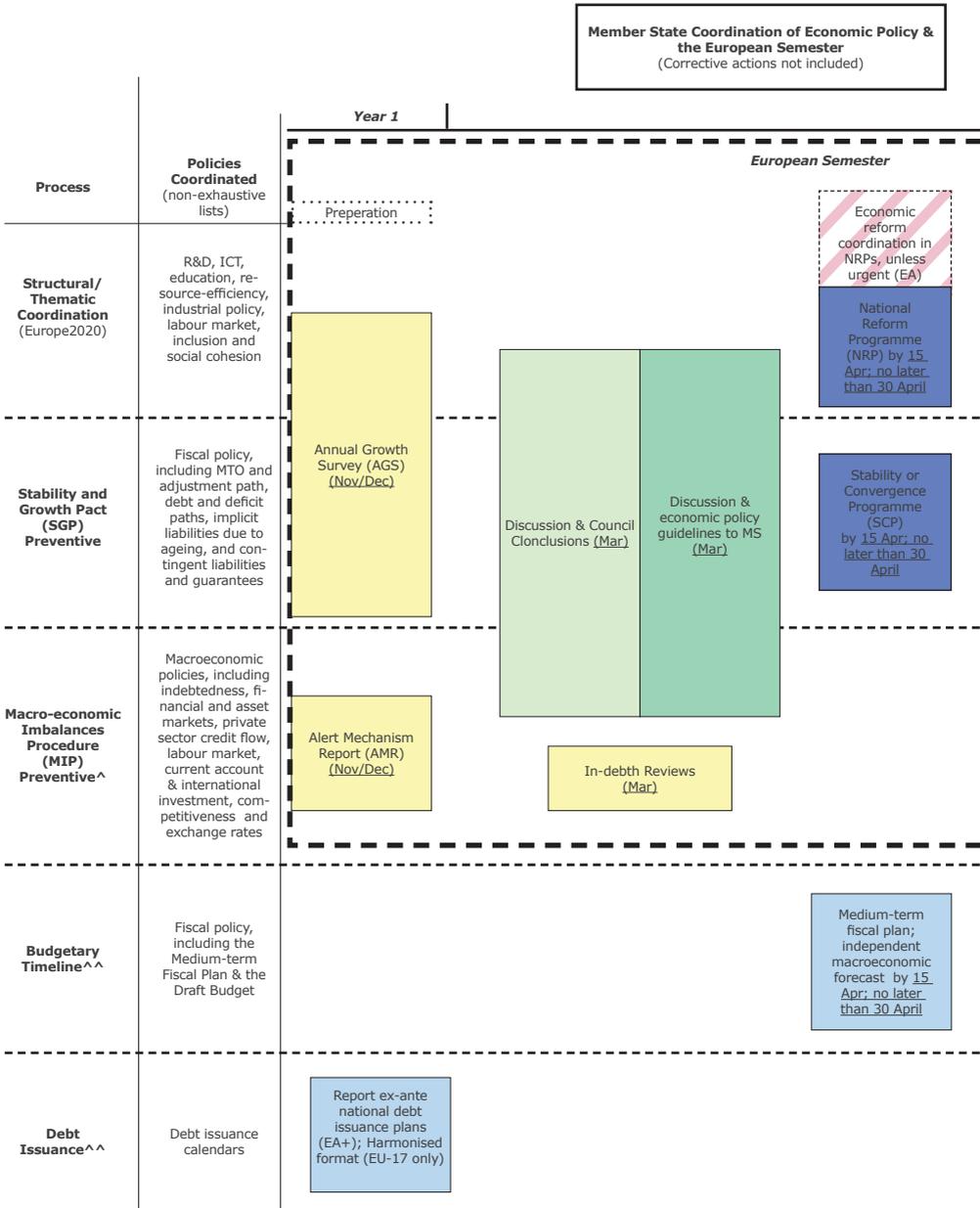
5. Decreasing the number of Europeans in or at risk of poverty and social exclusion by 20 million people.

All Member States are committed to these targets which are translated into national targets. Moreover, the Commission put forward seven flagship initiatives - digital agenda for Europe, Innovation Union, Youth on the move, resource efficient Europe, an industrial policy for the globalization era, an agenda for new skills and jobs and a European platform against poverty - with European and national action fields to underpin these targets. The desired impact on growth can only be accomplished, if the individual efforts of the Member States are implemented in a coordinated and focused manner.

The cornerstone of the new mechanism is the so called European Semester - a cycle of economic policy coordination: Commencing with the adoption of the Annual Growth Survey (AGS) by the European Commission, usually in January (or towards the end of the year), setting out EU priorities and providing Member States with policy guidance to boost growth and employment in line with the Europe 2020 Strategy. In March, the European Council issues guidance for national policy priorities based on the AGS and sets the basis for the formulation of the national budget policy (Stability and Convergence Programmes - SCPs) and structural policy (National Reform Plans - NRPs). The guidance covers fiscal, macro economic and structural reform. In April, Member States submit their plans for public finances (SCPs) and national policy (NRPs) to the European Commission. In May/June the European Commission assesses these programmes and issues country-specific recommendations (CSRs). In turn, the recommendations are discussed by the Council and endorsed by the European Council. Finally, the Council formally adopts the country specific recommendation in June/July. Hence, policy advice to Member States is provided before they start to complete drafting their budgets for the following year. In the second half of the year, Member States should implement the recommendations within their national policies. If the CSRs are not enacted within a given time-frame, policy warnings can be issued. Moreover, in the case of excessive macroeconomic and budgetary imbalances sanctions can be imposed.

Graph 1: Governance of EU coordination

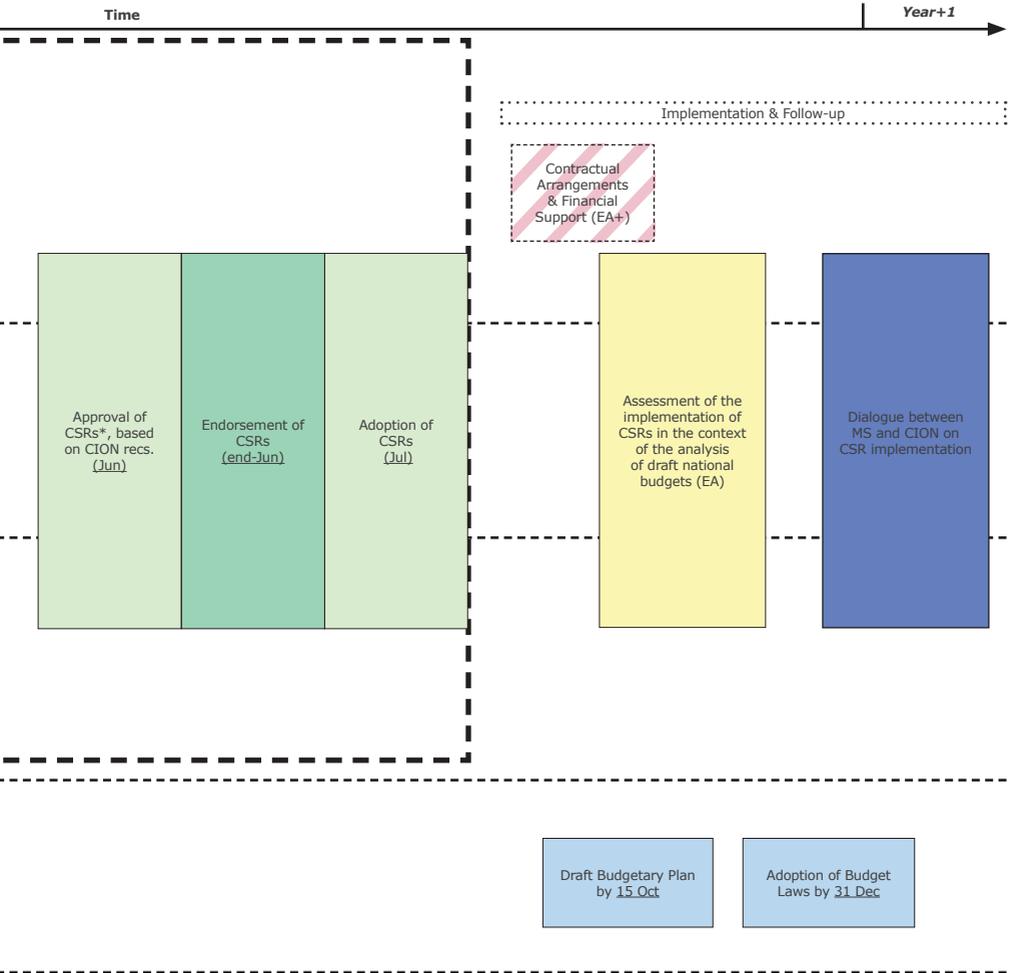
Source: Council Secretariat



- Commission Action
- MS Action (Euro Area)
- MS Action (EU-27)
- EC Action
- Council Action
- Envisaged in Commission Communications 20.3.2013

- This chart provides a general view on the main elements of the economic policy coordination, including the preventive arm of the SGP. Actions under the corrective arms of the MIP an SGP have been excluded. Additional economic policy coordination of Member States under stress (Two Pack) is excluded.
- The map omits any actions by the EU institutions outside the European Semester.
- Reporting requirements under the European Semester for countries under an Excessive Deficit procedure (corrective) or under a Macroeconomic Adjustment Programme are suspended.
- CSRs stands for Country Specific Recommendations; EA stands for Euro area.
- Introduced in "Six Pack"; ^^ Introduced in "Two Pack"

Date: 21.3.2013



The so called "Six Pack" - five regulations and one directive - entered into force on 13 December 2011. It applies to 27 MS with some specific rules for euro area Member States, especially regarding financial sanctions. The Six Pack does not only improve fiscal surveillance by strengthening the Stability and Growth Pact (SGP), but also focuses on excessive macroeconomic imbalances. As regards the SGP, the new legislation addresses gaps and weaknesses identified during the crisis. The SGP consists of a preventive and a corrective arm. The cornerstone of the preventive arm is fulfilling the medium-term budgetary objective (MTO), which is a country-specific reference value of "close to balance or in surplus" for each Member State's budgetary structural position. Member States are required to reach their MTO or be on an appropriate adjustment path towards it. Annual expenditure benchmarks are now used alongside the structural budget balance to assess the Member States progress towards the MTO. If euro area Member States deviate markedly from the adjustment path and the expenditure benchmarks, a financial sanction may be imposed on them.

The corrective arm includes the Excessive Deficit Procedure (EDP), which aims at avoiding an excessive deficit situation and ensuring that Member States adopt appropriate policy responses to correct excessive deficits. Countries placed in EDP are requested to comply with recommendations to reduce their excessive deficit within a given time-path. Thus far, an EDP was launched on the basis of a deficit above 3% of GDP. The new rules of the Six Pack allow for a stronger corrective action by reinforcing the previously neglected debt criterion - government debt ratio at or below the 60% of GDP threshold or sufficiently diminishing towards it. The launch of an EDP may now also be triggered on the basis of the debt ratio, if the gap between the debt level and the 60% of GDP reference is not reduced by 1/20 annually over an average of three years. The debt criterion is also fulfilled if the budgetary forecasts of the European Commission indicate that the required reduction in the gap will proceed over the three-year period encompassing the two years following the final year for which the data is available. Progressive financial sanctions kick in at an earlier stage and may already be imposed on Member States when an excessive deficit is identified, provided that the concerned Member State was subject to financial sanctions under the preventive arm. Thus, Member States are being sanctioned in a gradual

way, from the preventive arm to the latest stages of the EDP. Moreover, the Six-Pack introduced the reverse qualified majority voting (RQMV) for many steps in the procedures, which implies that a recommendation or proposal of the European Commission is considered as adopted in the Council unless a qualified majority votes against it.

As part of the Six Pack, the macroeconomic imbalance procedure (MIP) has been set up as the new surveillance and enforcement mechanism to identify and correct macroeconomic imbalances at an earlier stage. An early warning system, which consists of a limited set of scoreboard indicators, serves as a filter for major sources of macro-economic imbalances. The indicators cover external imbalances (current account balance, net international investment position, price competitiveness in terms of unit labor costs, real effective exchange rate, export market share), as well as internal imbalances (public and private sector debt, private sector credit flow, house prices, total financial liabilities and unemployment). The scoreboard is not interpreted mechanically but accompanied by an economic reading. In cases of actual or imminent macroeconomic imbalance an in-depth review (IDR) is undertaken. If the European Commission concludes that imbalances exist, either preventive recommendations (preventive arm of the MIP) may be adopted or - in the case of excessive imbalances - the corrective arm of the MIP is made operational by the Excessive Imbalance Procedure. This may finally lead to sanctions for euro area Member States if they repeatedly fail to meet their obligations.

Additionally to the Six Pack, the regulations of the so called "Two-Pack", which entered into force on 30 May 2013, aim at further strengthening the surveillance mechanisms in the euro area and are applicable to euro area Member States only. It introduces special rules applying to Member States in the EDP (e.g. the requirement for Member States to prepare economic partnership programmes) and sets out clear and simplified rules for enhanced surveillance for Member States facing severe difficulties regarding their financial stability, those receiving financial assistance, and those exiting a financial assistance programme. In order to allow timely action, euro area Member States must publish their draft budgets by 15 October and adopt their budgets for the following year by 31 December. The European Commission will examine and give an opinion on each draft budget by 30 November and may ask the Member State to submit a revised plan where appropriate.

The Fiscal Compact (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) is not part of the EU law, but is an intergovernmental agreement was signed by all EU Member states except the Czech Republic and the United Kingdom and entered into force on 1 January 2013. It aims to strengthen fiscal discipline and requires the national budgets to be balanced or in surplus. According to this new treaty, debt brakes must be introduced into national law by restricting the structural deficit to a maximum 0.5% of GDP, in case of debt levels of below 60% and no significant costs of ageing up to 1%. An automatic correction mechanism must be implemented by each Member State which is automatically triggered in case of significant deviations from the MTO or the path towards it. A fine up to 0.1% of GDP may be imposed on Member States which do not comply with the rules of the Fiscal Compact.

Financial support measures are key elements of the European crisis management: Starting with bilateral loans in the form of a financial rescue facility adopted in May 2010 for Greece the framework has been expanded to the European Stability Mechanism (ESM), an international financial institution. The ESM was established by treaty and entered into force on 27 September 2012. It was finally inaugurated on 8 October 2012 upon completion of the ratification process by participating euro area Member States. The ESM raises funds up to € 500 billion by issuing money market instruments as well as medium and long-term debt. The ESM has a total subscribed capital of € 700 billion, of which €80 billion are in the form of paid-in capital provided by the euro area Member States.

As the crisis started in the financial sector, it was soon evident that major efforts were necessary to enhance the financial market integration, regulation and supervision. Thus, reforms on EU-level have been focused on this area: The new Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR) incorporate the capital rules of Basel III into European law. As regards the supervision of the financial markets, the European System of Financial Supervision (ESFS) was established in early 2011 with a view to safeguard the application of financial sector rules in the Single Market. The ESFS also aims to contribute to the maintenance of financial stability and the confidence in the financial system as a whole. It consists of

the European Systemic Risk Board (ESRB) at the ECB and the three European Supervisory Authorities, European Securities & Markets Authority (ESMA), European Banking Authority (EBA) and European Insurance and Occupational Pensions Authority (EIOPA). In addition to other measures (such as MiFiD, a regulation for investment services, or the increase of the minimum amount of the Insurance Guarantee Scheme), first steps have been taken to implement a single rulebook and a single supervisory mechanism for banks as well as a single Resolution Mechanism to deal with banks in difficulties.

Long term development of the EU

In November 2012, the European Commission published a blueprint for a deep and genuine EMU. In the short term, existing proposals (e.g. the Banking Union, Two Pack, Multiannual Financial Framework) should be implemented. In the medium term, i.e. 18 months to 5 years, further strengthening of the budgetary and economic policy could go hand-in-hand with a dedicated fiscal capacity for the euro area. This fiscal capacity should rely on own resources. It should be able to provide even large Member States under stress with sufficient support for important structural reforms. Moreover, it is proposed to take short-term eurobills or a debt redemption fund, subject to strict conditionality, into account. In the longer term, i.e. beyond 5 years, an autonomous euro area budget should be established. It would be a prerequisite for a fiscal capacity for the EMU providing incentives to design and implement structural reforms on a basis of contractual arrangements while (also) supporting adjustment to asymmetric shocks. A deeper integrated economic and fiscal governance framework should allow a common issuance of public debt. As a result, the final level of economic integration of the EMU would be achieved. The Commission emphasizes that the inevitable treaty change must be combined with a stronger democratic accountability conferring further supranational powers on the EU level. The blueprint describes the necessary instruments and steps for achieving a comprehensive Banking, Economic, Fiscal and Political Union. This entails a deepening of the EMU. Graph 2 gives an overview of the timetable.

Graph 2: A blueprint for a deep and genuine EMU

Source: European Commission

			A blueprint for a deep and genuine EMU Launching a European debate	Secondary law	Treaty change
			ALL ALONG THE PROCESS Short Term Within the next 18 months Medium Term 18 months to 5 years Longer Term Beyond 5 years		
2. Banking Union : Financial regulation and supervision: quick agreement on proposals for a Single Rulebook and Single Supervisory Mechanism	✓				
3. Banking Union: Single Resolution Mechanism	✓				
4. Quick decision on the next Multi-annual Financial Framework	✓				
5. Ex-ante coordination of major reforms and the creation of a Convergence and Competiveness Instrument (CCI)	✓				
6. Promoting investment in the Euro Area in line with the Stability and Growth Pact	✓				
7. External representation of the Euro Area	✓				
1. Further reinforcement of budgetary and economic integration	✓	✓			
2. Proper fiscal capacity for the Euro Area building on the CCI	✓	✓			
3. Redemption fund		✓			
4. Eurobills		✓			
1. Full Banking Union		✓			
2. Full fiscal and economic union		✓			
Political union: Commensurate progress on democratic legitimacy and accountability	✓	✓			

The blueprint represents the Commission's contribution to the report of the four presidents - the European Council's Herman Van Rompuy, the European Commission's José Manuel Barroso, the Eurogroup's Jean-Claude Juncker and the ECB's Mario Draghi - „Towards a genuine Economic and Monetary Union“ presented in December 2012. This report also underlines the importance of implementing the existing proposals in the short term, i.e. the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance. An integrated financial framework would necessarily be combining a single European banking supervision, a common deposit insurance and resolution framework. In a medium perspective, the issuance of common debt could be explored. Finally, a fiscal capacity, capable of addressing imbalances and adjusting to shocks for the EMU should be built up while ensuring the necessary

democratic legitimacy and accountability of decision-making within the EMU.

The conclusions of the European Council held in December 2012 state that the focus of the debate in the next months should be on:

- ex-ante coordination of major economic reforms,
- social dimension of the EMU,
- Convergence and Competitiveness Instrument (CCI),
- financial solidarity mechanisms.

In March 2013, the Commission published two communications: „The Communication on the ex-ante coordination of plans for major economic policy reforms“ contains different options on how to discuss at the EU-level major economic reforms to be implemented in the Member States before the final decisions are taken at national level. Above all, measures with spill-over effects on other Member States are to be discussed. „The Communication on a Convergence and Competitiveness Instrument (CCI)“ deals with contractual arrangements for Member States to undertake specific reforms combined with financial support to help Member States implementing these reforms.

Different Council formations, i.e. the Employment, Social Policy, Health and Consumer Affairs Council (EPSCO) in February, Economic and Financial Affairs Council (Ecofin) in March and the Competitiveness Council (COMPET) during its informal meeting in May have already discussed the present proposals. They all concluded that further discussion is needed on these issues. It is not expected that the Council Conclusions of the European Council in June 2013 will go beyond the previous discussions - the President of the European Council will be asked to continue its work in close cooperation with the President of the European Commission.

Authors

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- The development of several policy areas: employment, education, innovation, research, regional and industrial policies
- Special EU initiatives: the new Erasmus for mobility, New Skills for New Jobs
- The responses to the euro-zone crisis
- The final negotiation of the Lisbon Treaty

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