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THE LESSONS OF THE EUROZONE CRISIS THAT SHOULD SHAPE THE EU'S G20 STANCE

by Yannos Papantoniou,

Former Economy and Finance Minister of Greece

Foreword by Herman Van Rompuy

Spring 2011

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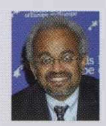

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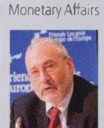

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Co-President, Initiative for Policy Dialogue, Columbia University, and Nobel Prize laureate

From the author

Writing this report has been both a challenge and a pleasure. Coming back to issues such as eurozone governance and financial reform that I had previously dealt with as a politician, and looking at them in a more academic and systematic way, has been enjoyable. But it has certainly been a challenge to deal with them in today's turbulent times.

Without pre-empting this report and the ideas running through it, I should emphasise that my analysis lends support to the view that the modern economy has become so global that managing it needs a new and distinctly more globalised institutional set-up than the present nation-centred ones. Supranationality is becoming the order of the day at both European and world levels of governance.

My thanks must go primarily to Sébastien Fontenay, who made a substantial contribution on both research and the preparation of drafts for the report. I have also greatly benefited from discussions with Laurent Fabius, Jean Pisani-Ferry, Marco Buti and Giles Merritt, as well as with friends from the academic world. I of course remain solely responsible for the content.

The report relies on information available until the end of 2010. Subsequent developments could not be taken into account. However, they can be interpreted in the light of the analysis presented here.

I am grateful, as a *Friends of Europe* Fellow, to Etienne Davignon and all at *Friends of Europe* for giving me the opportunity to present my views to a wide and influential audience.

Yannos Papantoniou,
Former Economy and Finance Minister of Greece (1994-2001)

Foreword

By Herman Van Rompuy, President of the European Council

This is an important and timely study on an essential problem of European policy making. The destinies of the world's main economies are more intertwined than ever before. That's why European leaders want to take the lead in a global discussion which affects economic growth and the jobs and welfare for our citizens.

Yannos Papantoniou rightly urges us to draw the lessons from the global economic and financial crisis and from the public debt crises within the eurozone. That is exactly what we are doing. His recommendations underline the necessity of the decisions the European Union has taken in the past year and the urgency to implement them fully.

In twelve months time, we have fundamentally improved the working of the Economic and Monetary Union. We have built crisis mechanisms to safeguard the financial stability of the eurozone and we have worked hard on the prevention side. Fiscal surveillance is substantially improved thanks to a stronger stability and growth pact. A new form of macro-economic surveillance has been put in place, allowing us to better monitor divergences and the risks of housing bubbles and other vulnerabilities. Finally, 23 of our 27 countries concluded the Euro Plus Pact to strengthen economic policy coordination to enhance competitiveness.

As a consequence, I do not share the author's verdict that the EU's actions were insufficient. In order to prevent further crises, we now have a strong combination of institutional pressure (including sanctions), financial pressure (via the financial markets) and political pressure (or peer pressure). Furthermore, one should not underestimate the political will among Heads of State or Government or finance ministers to avoid a repetition of the crisis. Nobody wants to live that experience again.

I am aware that more ideas and proposals circulate, some mentioned by the author. The number one priority however is to implement the decisions we have taken and which, I am convinced, will suffice to deal with the situation.

Yannos Papantoniou stresses that the global economic governance should be improved in the same manner. Indeed, we face global risks to financial sustainability, high unemployment, volatile commodity prices and macroeconomic imbalances – all priorities for the French G20 Presidency. The European Council will carefully prepare the upcoming G20 summit in Cannes, like we did in 2010. In Toronto and in Seoul, where together with the President of the European Commission I represented the European Union, the ground was prepared for further progress.

In closing this fascinating study a question springs to mind: Why is it more difficult at the global level to draw the lessons from the crisis than for the European Union? One reason, the author suggests, is that the Union already has a decade-long experience of finding common solutions to common problems, of seeing the national interest (also) in terms of the wider European interest. Thus we may hope that a similar habit of collective problem-solving grows over time within the G20 as well. However, another trigger for common action that we have in the EU is lacking globally. The secrets to the European crisis response were the internal market and the single currency. When our common European achievement was at stake, we were able and willing to act rapidly, robustly and responsibly. We did that, and we would do so again.

And of course, 'Europe' is more than an economic project. It is a political project. It is the choice for a society in which peace, a social market economy and political democracy are secured.

Herman Van Rompuy
Brussels, April 2011

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1 Reforming Economic Governance: The Challenge for Europe and the World

The twin crises the world has suffered from during the past three years, namely the global financial crisis and the sovereign debt crisis originating in the eurozone, highlighted a fundamental truth of economics; large imbalances in either the real economy or the financial sector, or both, are bound to disrupt the functioning of economic systems.

After a long period of stability, particularly if it is coupled with steady growth, this truth tends to be forgotten and crises erupt with potentially disastrous economic and social consequences. A learning process starts again, hopefully producing new solutions on how to prevent and, when necessary, redress imbalances so as to recreate conditions of stability and growth.

The world is currently going through such a process. Innumerable meetings and discussions have been held during the last couple of years among politicians, businessmen and academics across the world to analyse and understand what has happened, why it has happened, and to decide on how to prevent it happening again.

The outcome of this learning process is not altogether disappointing. A growing consensus seems to have emerged, for instance, on what the European Union (EU) needs to do to escape the eurocrisis. Agreement is more modest as far as the global economy is concerned, but this could be explained by the co-existence of more established and newer powers, with radically different histories, cultures as well as political systems, that are not accustomed, – as European nations are – to working together for the common good. In fact, in the world at large, the notion of the common good is elusive, as is being amply demonstrated by the persisting reluctance to face up to the problems of climate change and exhaustible resources.

It is no exaggeration to say that Europe has a unique chance to lead by example, and thereby capture the heights of the global economy. At a time of growing threats to our security from non-military sources such as climate change, demographic shifts, pandemic disease and failing governance, a stronger European presence may prove to be helpful.

Europe is uniquely placed to play a more forceful role in the global effort to reform economic governance. Having gained first-hand experience over a number of decades in managing international policy systems, it can contribute constructively to designing a new architecture for enhanced global economic cooperation while according a fair deal to emerging economies.

France has recently taken over the presidency of the G20, and in January will combine that with the presidency of the G8 grouping of major industrialised nations, offering the EU an opportunity to adopt a common stance. Although there have been divergent national views, both inside the EU and with the United States, there are a number of areas where agreement on global rules can be achieved.

1.1 Global Economic Governance

At the origin of the global economic crisis lies the huge current account imbalances that have been built up over the last decade producing an unusual pattern of savings flows. Poor countries, chiefly China, have been financing rich ones, such as the United States. This pattern reflects the fact that emerging countries have had large current account surpluses, whereas developed economies have accumulated sizeable deficits. The imbalances led capital to flow "the wrong way" from the developing to the advanced economies, destabilising the financial system and eventually leading to the economic crisis.

The existence of a savings glut at the global level depressed world interest rates and stimulated a search for higher yields. Excessive liberalisation and inadequate supervision of the global financial system allowed banks to accept dubious lending projects, and invent and proliferate questionable derivatives thus spreading the crisis to the rest of the world. Excess savings of poorer countries indirectly financed a U.S. consumer boom and also supported consumption in other advanced economies. But, as Samuel Brittan (2010) noted, "consumer debt ratios could not go on rising for ever, and had it not been the U.S. subprime crisis, some other trigger would have set off the recession".

The challenge for world leaders is to ensure no repeat of the financial crash that pushed the world into recession. Enhancing policy coordination and laying down a new rulebook for global financial services must provide an essential part of the EU's G20 agenda.

> **Policy Coordination.** The lessons from the eurozone's crisis essentially consist of the need to establish mechanisms and procedures for preventing, and if necessary redressing, real or financial imbalances. At the global level there is no scope for promoting integration. However, there is an urgent need to achieve better policy coordination, particularly as concerns demand management and exchange rate policies. The G20 should take the lead in evaluating economic policies and issuing appropriate warnings against developments threatening global stability. The problem of persisting global external imbalances must be addressed immediately. Currency wars and a generalised rush to drive down exchange rates are not an efficient way to achieve better balance in the world's current accounts while they risk provoking protectionist reactions. As such, care should be shown in the effort to convince China to let the renminbi's value rise. Changes from top to bottom may produce dislocations with negative economic and social repercussions. As Dominique Strauss-Kahn, Managing Director of the International Monetary Fund (IMF), has suggested, the necessary revaluation of China's currency should be related to a change in demand policies oriented towards reducing the country's export dependence.

The creation of a permanent G20 secretariat, endorsed by France as a major item on its G20 presidency agenda, is needed to achieve more effective coordination. It should have a light structure, designed to analyse policy options and present them to G20 leaders and should complement rather than antagonise the IMF, which should further develop its function as the main surveillance agency for the world economy.

Controlling global imbalances also requires limiting foreign currency accumulation in developing countries, which is achieved primarily through large current account surpluses and sustained by undervalued exchange rates. The traumatic experiences of the early 1980's Latin American crisis and of the late 1990's Asian crisis pushed developing countries to build reserves as a form of self-insurance against the risk of "sudden stop" in capital flows. Lack of trust in the multilateral insurance agency, the IMF, tends to perpetuate this tendency.

Rebuilding confidence in the IMF forms a significant part of the reform agenda for global economic governance. Under the present leadership of Dominique Strauss-Kahn several steps have been taken in this direction. The fund's resources have been increased, although the drive for further increase should continue. Crucially, however, the representation of developing countries should be substantially reinforced at the expense of advanced countries, and particularly of the EU. Otherwise the IMF will continue to be seen as an instrument of the rich world. Eurozone member states should agree to having a single seat at the executive board, the EU's voting rights should be reduced and the U.S. should give up its veto over important decisions.

The decision at the G20 summit in Seoul to shift quota shares and voting rights to developing countries falls short of the necessary realignment but goes some way to enhance the credibility and the effectiveness of the Fund. The G20 should push for more radical reform in the near future.

> **Finance.** Inadequate regulation and supervision of financial markets played a significant part in explaining the intensity of the global economic crisis. Excessive liberalisation as well as the laxity of supervisory frameworks allowed banks and other financial institutions to drastically lower the standards of their lending policies and devise composite financial instruments embodying risk elements that were not easily identified and appreciated. A radical overhaul of the existing regulatory and supervisory system is needed that should aim to reinforce the micro – and macro – prudential framework in a way that enhances the resilience of financial institutions against a wide range of potential shocks.

The U.S., the EU and other players in the global economy have already initiated reforms within their jurisdiction. But it is the responsibility of global authorities to ensure that these reforms are consistent, sufficient and fully operational for the entire world economy. Only in this way will an effectively protective wall emerge against future crises.

Commentary — **Edmond Alphandéry**, Chairman of the Board of Directors, Caisse Nationale de Prévoyance (CNP), and Former French Economy Minister

"I share the author's overall analysis of the origins of the financial crisis except on one important point: I do not think that the pre-crisis world was suffering a "savings glut". This "savings glut" story is very dangerous because, applied today, it would lead to more quantitative easing or fiscal profligacy."

Most of the decisions needed to build a global financial system solid enough to sustain stable and lasting economic growth still lie ahead. In particular, the following issues should be handled at global level:

- Effective Regulatory Framework. The new rules agreed recently by the Basel Committee on Banking Supervision mark a significant improvement in the quality and quantity of bank capital. Higher capital and liquidity requirements shape a tougher regulatory framework. It is essential, however, that regulatory perimeters are properly drawn so that all systemically important financial institutions are included and that purpose-built legal entities cannot be utilised to hide risks from supervisory oversight.

- Strengthened Supervision. Weakness of supervision was as responsible as flawed regulation for ushering in the crisis. It is crucial to endow supervisory agencies with the necessary resources and capacity for acting, particularly as concerns operational and enforcement decisions, without reference to political or other considerations. Progress in this area has been very limited so far.

- Resolution. Resolving large, cross-border financial firms represents a great challenge for financial stability and the public sector. A resolution mechanism should aim at ensuring that no institution would be viewed as "too big to fail". The complexity of the problem, as presented at the global level, has not allowed any progress so far. For this reason the IMF has recently proposed a "pragmatic approach" focused on establishing an enhanced coordination framework based on an agreement on standards, criteria and procedures for jointly implementing resolution measures across borders. Some progress in developing resolution mechanisms is being made at the individual country level, as is the case in the U.S. and the UK. The EU is behind the curve in this crucial issue, highlighting the need for much more vigorous action at the global G20 level.

- Regulating Systemically Important Financial Institutions (SIFI). The imposition of specific prudential rules on SIFI's reflecting the greater risks these institutions pose to the financial system is critically important for reducing risk for the system as a whole. Examples of such rules are systemic risk-based capital surcharges, systemic levies – in proportion to systemic importance – or structural constraints on the size, the legal structure, or the activities of financial firms so as to limit complexity and risk taking. Work on this issue is under way.

- Reinforcing Market Infrastructure. Well-functioning markets enhance the resilience of the financial system. Confidence that trade contracts will be honoured as well as ensuring transparency prevails in their transactions are essential for minimising market disruptions. A lack of these in the trade of innovative products, such as over-the-counter (OTC) derivatives, acted in a destabilising fashion for the financial system. Tougher regulation is required, particularly as concerns hedge funds and other alternative investment funds as well as the trading of derivatives. Regulatory reform should also be extended to financial instruments and practices such as naked short selling and Credit Default Swaps (CDS) so as to create a level playing field and eliminate the incentive for financial institutions to migrate to less regulated countries. Despite the measures taken in individual countries, progress in this area of the reform agenda remains very limited at the global level.

There is a great deal of work to be done by the G20 in order to secure the stability of the financial system. The IMF and the newly created Financial Stability Board (FSB) could supply critical support by providing early warnings about macroeconomic and financial risks, and eventually suggest mitigating actions. The EU should take the lead by insisting on moves to strengthen supervision, create cross-border resolution mechanisms, and apply tougher rules on systemically important institutions, on hedge funds as well as on the trade in derivatives. The EU should press firmly its position for stricter rules as opposed to the more liberal attitudes expressed by the U.S. and the UK, taking into account that the *laissez-faire* approach of recent years bears a significant share of responsibility for the severity of the financial crash.

> **Trade and Aid.** Protectionism and inadequate financial assistance exacerbate economic and social problems in developing countries by increasing poverty and inequalities, and retarding growth. Protectionist measures deeply penalise poorer countries that rely on a restricted number of export products, notably crops and minerals. At times of crisis the worsening of economic and social conditions takes on dramatic dimensions. Estimates from the World Bank suggest that the crisis brought an additional 50 million people to a state of extreme poverty in 2009 and will bring some 64 million more by the end of 2010, relative to a no-crisis scenario.

It is critically important for ensuring stability and social cohesion in developing nations to immediately reverse protectionist tendencies and improve the trading prospects of poorer countries, in line with recurrent pledges of world leaders. The EU should be in the driver's seat and take initiatives to unlock trade negotiations in the context of the Doha Round. Decreasing export subsidies for agricultural products and raising the share of poorer nations' products that enter the markets of advanced countries duty-free are key items of a liberalising Doha deal. In the absence of a deal, the EU, together with the U.S., should push for an early acceptance of a provisional accord on trade facilitation. The creation of a fund under the WTO could help developing countries meeting the provisions of the new agreement. As the main forum for strategic global impulse, the G20 should sustain the effort to check protectionism and promote trade liberalisation in favour of developing countries.

Concerning development assistance, the yardstick is the Millennium Development Goals (MDG). In 2000 at the United Nations, advanced economies pledged to dedicate 0.7% of their Gross National Income to development assistance by 2015. Today, only five countries have reached this objective, namely Sweden, Norway, Denmark, Luxembourg and the Netherlands. None of whom are members of the G20. If the G20 wishes to maintain credibility as a leading global institution, it should push its members to reach the 0.7% target within the next five years.

At the same time, G20 countries should attempt to improve the coordination of development assistance so as to increase effectiveness in its use. It has been suggested that the multilateral arm of assistance should be reinforced because it offers better guarantees for efficient use. Barack Obama, the U.S. President, supports the idea of rewarding efficient users with more say on the way they utilise the funds. Raising global taxes, as recently proposed by the European Commission, could help in achieving Millennium Development Goals while reducing dependency on national funding. Aid is a powerful weapon for promoting development and reducing inequalities. Volumes and efficiency should be raised in parallel. Global taxes should be brought to the negotiating table. The task is enormous. The EU should take the lead and make aid a key item of its agenda for the G20.

> **Europe's G20 Agenda.** Europe, drawing on the lessons from the eurozone's crisis, is in an advantageous position to push for radical reforms in the system of global economic governance. The main elements of this agenda are the following:

- Reinforcing economic policy coordination through the creation of a permanent G20 secretariat, which, in cooperation with the IMF, will present world leaders with policy options addressing problems of stability and sustainable growth in the global economy. The immediate task is to address current account imbalances by promoting exchange rate realignments combined with appropriate adjustments in fiscal policy.

- Raising the representation of developing countries in IMF's executive board by a further redistribution of voting rights at the expense of advanced countries. Eurozone countries should have a single seat confirming their unified position and enhancing the status of the euro.

- Pushing for a new global financial services rulebook comprising tougher regulation for systemically important institutions, hedge funds and derivatives' trade, strengthened supervision as well as the creation of cross-border resolution mechanisms.

- Taking the initiative for checking protectionism and promoting trade liberalisation as part of a wider development agenda. Decreasing export subsidies for agricultural products is a key issue in the Doha Round negotiations. In the absence of a deal on Doha, the EU should push for a provisional accord on trade facilitation, which would demonstrate the commitment of advanced countries to promote trade as a vehicle of economic development.

- Taking the lead, in the context of the G20, for raising aid volumes to the level called for by the Millennium Development Goals, and reforming coordination so as to improve efficiency. Reaching the MDG targets in five years, reinforcing multilateral aid and raising global taxes are the main items of the aid agenda.

1.2 Eurozone Governance

In line with developments in the global economy, large external imbalances were allowed to emerge over the last decade within the eurozone. The competitive position of peripheral member countries, particularly Greece, Spain, Portugal and Ireland, deteriorated sharply as measured by unit labour costs *vis-à-vis* the core countries of the eurozone. Governments in the periphery ignored warnings and turned a blind eye to the accumulation of credit-fuelled bubbles and public or private debt while they failed to take anti-cyclical fiscal measures or promote structural reforms for improving competitiveness. Large peripheral external deficits were matched by surpluses in Germany and other core countries. The persistence of these imbalances has transferred excess savings to the periphery creating the conditions for extensive borrowing, helped by the low money rates attached to the euro – as compared to those that historically prevailed under national currency regimes – on the part of both the private and public sectors. In fiscally responsible countries like Spain, excess savings resources have been borrowed by the private sector and invested in what later became bubbles – housing assets. The burst of the bubbles created problems of insolvency to the banks – as people were unable to repay their loans – while the bubble-induced recession, coupled with the disruption produced by the financial crash and the associated collapse in exports, led to an explosion of budget deficits and full-blown fiscal crises.

In fiscally profligate countries like Greece, the chain of events was more straightforward. Excess savings resources had mainly been borrowed by the government, leading directly to a fiscal crisis. Debt growth undertook catastrophic proportions after the financial crash when the recession led to drastic cuts in private spending and the automatic capture of redundant savings resources by the government.

An interesting, and critically important, part of the story is that much of the debt that was induced by the savings glut in core economies ended up, whether indirectly or directly, on government books of the peripheral economies.

The distinctive feature of peripheral economies is that, by being structurally weak as opposed to other countries facing similar problems, fiscal crises evolved into debt crises threatening to lead to sovereign defaults and a potential break-up of the monetary union. This is what makes a reform of the eurozone's system of economic governance extremely urgent and critical for the survival of the euro.

It has often been said that the euro is a monetary, not a political union. It possesses a central bank, but not a Treasury. The central bank can provide liquidity in times of crisis, though only a Treasury can address problems of solvency.

The challenge for Europe today is to make a qualitative step forward on the road to economic and political integration so as to equip itself with mechanisms that will effectively prevent and, if required, redress imbalances. Only thus will Europe be able to ensure the sustainability of the euro and create conditions for stability and growth, thereby enabling it to maintain its social model and punch its weight in the world.

Action is required on the following fronts:

> **Fiscal Integration and Policy Coordination.** Fiscal discipline is the foundation of a reformed system of economic governance. Discipline involves a higher degree of joint responsibility as well as sanctions for exceeding the deficit limits of the Stability and Growth Pact (SGP). Sanctions alone cannot work. They have not worked in the past and they will not work in the future, because external imposition provokes reaction and induces deviations in response to domestic pressures. Moreover, sanctions may prove to be counterproductive since they hinder the task of reducing the deficits and bringing them into line with SGP requirements. The idea, put forward by some influential EU voices, to transfer the responsibility for discipline to national authorities by imposing the adoption of national rules to guarantee long-term fiscal stability, is unlikely to work either. Germany has done it, but not all countries are Germany. National rules may help, but do not resolve the problem.

The only long-term solution that may work – at least most of the time – is to transfer some responsibility for setting and monitoring deficit limits to supranational institutions, such as the European Commission, the Ecofin and the eurogroup. This would reinforce "shared responsibility" and create a sense of collective purpose and, subject to negotiations, could be complemented by sanctions and national rules.

The Commission's proposal for a "European semester" offering a framework for analysing, and receiving guidance for, national budget policies is a step in the right direction. It is, however, inadequate, as have been most other similar non-binding initiatives, like the Broad Economic Policy Guidelines. The Commission, together with the Ecofin and the eurogroup, should be given additional powers for enforcing the broad directions of their budget recommendations.

To the extent that such powers are not consistent with existing treaties, a treaty revision, specifically designed to reinforce economic governance, is necessary and inevitable.

A larger goal of fiscal integration is to improve the coordination of economic policies. This comes up against the so-called "German problem". Frightened by the cost of unification, Germany promoted ambitious structural reforms to restore competitiveness, but also followed policies of wage restraint leading to stagnating domestic demand thereby widening the trade surplus. The huge external deficits of peripheral countries that led to the debt crisis stem from deficient macroeconomic and structural policies of the countries concerned, but they also reflect German policies.

Germany is understandably reluctant to modify its internally successful economic model. If, however, it insists in maintaining it, crises will recur. Moreover, if it proposes that other countries emulate it, Europe, including to some extent Germany itself, would be condemned to a prolonged slump which might even generate a new round of fiscal crises, possibly forcing some peripheral countries to default on their debts.

The key point is that most of the imbalances have arisen in the private sector, except in Greece, and all relate to large external deficits. The overshoot, in particular in Ireland and Spain, is due mostly to developments in the private sector or to public sector guarantees of the banking system. Neither these nor the question of external imbalances are subject to the SGP.

It is, therefore, obvious that overall policy coordination should be strengthened. The additional powers that will have to be accorded to the Commission, the Ecofin and the eurogroup should be partly directed to ensure that EU authorities get a significant say in determining the course of economic policies of eurogroup members. To this end not only deficits but also debt levels as well as financial and competitiveness indicators should be closely monitored, and included in the surveillance process by the Commission. Fiscal policies should be determined by taking into account the growth prospects of the eurozone as a whole as well as the fiscal, financial and competitive positions of individual countries. Fiscal contraction in one part of the area should be compensated for by a more expansionary stance in some other part.

> **Financial Integration.** The global crisis revealed several cracks in the European financial system. Regulatory and supervisory regimes were excessively fragmented along national lines for dealing with a crisis of global dimensions. Warning systems did not work while interventions were patchy and uncoordinated as a result of disparate rules and the existence of a multitude of relevant authorities. Following the lines suggested in the de Larosière report, the EU decided to establish four new bodies of financial supervision. The European Systemic Risk Board would protect the stability of the financial system and be responsible for macro-prudential oversight. Separate Authorities for European Banking, Insurance and Occupational Pensions and Securities and Markets would be in charge of micro-prudential supervision. However, as implied by the Commission's obligation to review every three years whether these bodies should be entrusted with additional powers, the new system lacks the instruments for ensuring effective financial supervision. The move to supranationality is, again, too timid, because national authorities succeeded in retaining the core of the relevant powers.

Moreover, a genuine European crisis resolution mechanism should be put in place to address problems of financial institutions falling into the category of "too big to fail". The mechanism should be based on a financial stability fund to bail-out banks that are in trouble. The financing of such a fund should rest on supranational sources, such as deposit insurance fees and bank levies.

Furthermore, the EU should establish a common rulebook for the 27 member states, regulating naked short selling and Credit Default Swaps so as to increase transparency in financial trading.

Europe is still far below the required degree of integration concerning regulatory and supervisory functions in a financial system that has already achieved a high degree of homogeneity.

> **Bail-out Mechanisms and Crisis Resolution.** However tight the disciplinary regime for fiscal policy may eventually become, the risk of policy failure cannot be excluded. In a monetary union with many members, facing over time variated circumstances, deviant behaviour or sheer incapacity to meet targets, constitutes an inherent long-term risk. It is, therefore, essential to equip the eurozone with mechanisms capable of addressing such problems by providing financial relief to countries in trouble and helping them to bring their finances in order.

In May 2010 eurozone leaders embraced two bold moves in order to save the Euro, which came close to collapse under the weight of debt accumulated in some member states. The bail-out of Greece amounts to € 110bn. while the European Financial Stability Facility (EFSF), created to support future debtor countries facing the risk of default, rests on resources amounting to a total of € 750bn.

These moves showed that monetary union forces its members to provide assistance to their weaker partners, bypassing the relevant stipulation of the Treaties, irrespective of whether they want it or not. However, the EFSF is an *ad hoc* mechanism lacking solid finance and perspective.

Bilateral loans from eurozone countries constitute the main part of its financial base and it will expire after three years. The eurozone's long-term survival will depend on its capacity to turn the EFSF into a permanent, properly funded agency capable of providing assistance and, eventually, managing default procedures in a credible way.

Commentary — **Wolfgang Münchau**, Associate Editor, *Financial Times*

"The focus on competitiveness in the Lisbon Agenda and the Agenda 2020 may have contributed to the eurozone's internal imbalances. In a report of such breadth, it would have been appropriate to question the relevance of the European Commission's agenda and ask whether a 1990s-style approach to structural reforms is indeed the answer to this financial crisis. One may come to the conclusion that this is the case, but one cannot simply assume it. I get the impression that the author is trying to be politically correct and please some constituents."

Such an agency could take the form of a European Stability Mechanism (ESM) that would finance assistance programmes for eurozone countries that are in trouble. Funding should be sufficient to guarantee the stability of the eurozone as a whole, and should come through fiscal transfers from member states. "Orderly default" procedures involving the private sector should follow established international practice, as implemented in IMF programmes. Otherwise, they risk overcharging on borrowing costs, particularly for heavily indebted countries. Issuing Eurobonds, allowing countries to borrow on the basis of common rather than national liability, could also help alleviate the position of over-indebted eurozone members. The interest rate each country would pay could depend on the interest rate it pays in its own market although, on account of common liability, it would be lower. Specific mechanisms should be negotiated for ensuring that borrowing costs for core countries, such as Germany, the Netherlands and France, do not rise. Eurobonds lack effective conditionality that would trigger fiscal consolidation in over-indebted countries and thus they could not form the whole answer to the debt problem. However, they could supplement the creation of an explicit solidarity mechanism, such as the ESM, and be linked to it as an additional instrument of assistance.

The EFSF is a step in the right direction. However, as is the case with fiscal and financial integration, it falls short of what is required for securing the viability of the europroject.

> **Towards an EU Growth Strategy.** This is an essential part of the package of reforms that should be put in place for reinforcing eurozone performance. Raising productivity levels and reinforcing competitiveness will not only enhance Europe's position in world markets, but also help to promote convergence and cohesion within the EU so as to reduce the risk of allowing real imbalances to persist and create crisis conditions.

After the failure of the Lisbon Agenda, the Commission came out with a new 10-year plan titled "Europe 2020" which has been approved by the spring 2010 European Council. The plan includes initiatives for raising employment participation rates, boosting investment in research, cutting greenhouse gas emissions, improving education levels and lifting millions out of poverty.

If the plan is effectively implemented, it will make a significant contribution to the recovery of the EU's economy and the return to sustainable growth. However, despite the effort to tighten the monitoring of national reform programmes, the strategy continues to display weak governance and inadequate enforcement mechanisms. Peer pressure has not worked in the past, indicating the need for a more effective system of sanctions and incentives, "carrots and sticks", to ensure that member states meet the targets. Rewarding member states with extra EU funding for successful implementation of the reforms could be an effective incentive.

At the eurozone level, the peer review currently conducted by the eurogroup should be upgraded into a structured surveillance framework, implying stronger policy coordination.

A critical issue concerns the securing of the necessary resources for financing the plan, and particularly the seven "flagship initiatives" that make up the future EU agenda. Given past experience as well as the tight budgetary situation in most member states as a result of the crisis, credible finance could come, as already proposed by the European Commission, by letting the EU levy its own taxes on activities such as financial transactions or aviation. It looks like being the only way for Europe to fulfil its ambitious growth agenda while confirming its commitment to an "ever closer" union.

To conclude this discussion, a consensus is emerging on the necessary reforms of the eurozone governance system. A common thread running through them revolves around a substantial reinforcement of supranational institutions, procedures and instruments. The alternative is "muddling through", following a time-honoured trend in EU history. The challenge for the present leadership is to break this trend so as to open the way for making the euro as successful as it deserves to be.

Commentary — **Daniel Daianu**, former Romanian Finance Minister and former Member of the European Parliament

"A line of reasoning argues that the main source of the current financial crisis is the cheap money of the past, which would have caused large global imbalances as well. But more persuasive, in my opinion, is the view that something wrong has been happening with overall financial intermediation in recent decades. Structure has been no less important in derailing economies than misconceived policies and unavoidable cyclical dynamics.

Structure means rules and practices in the realm of regulation and supervision, on the one hand, and the practices of financial institutions, including securitisation and the growth of the shadow banking (which has escaped regulations), on the other. Structure has influenced policies through the neglect of systemic risks and the almost blind belief, by some, in the virtues of self-regulation and the clairvoyance of financial markets."

2 Eurozone's Performance during its First Decade

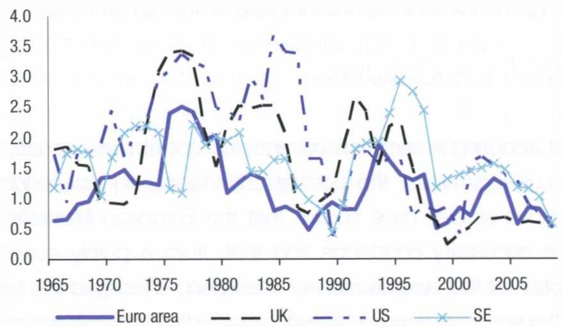
The benefits of adopting a common currency do not always exceed, according to the theory of currency areas, the cost of abandoning an independent exchange rate policy. Various studies have shown that the European Monetary Union does not fulfil all the necessary conditions and that, from a purely economic point of view, the adoption of the euro should not have been envisaged (De Grauwe, 1997). Nonetheless, the euro has become a reality, mainly thanks to strong political will, but also because the founding fathers believed that the obstacles could be overcome by deeper economic integration. More than one decade and a very severe economic crisis later, the debate on the fundamental soundness of this common endeavour has resurged. Such a re-evaluation of the euro ought to be based on a closer look at the currency's performance up to now, helping to shed light on the question of whether the eurozone has benefited from the adoption of the euro despite objections from economic theory.

First, we consider whether the implementation of the single currency fulfilled its goals, that is to say improving economic stability of the participating countries, and triggering growth of output and jobs. Second, we address the question of the efficiency of the European Central Bank (ECB)'s policy regime, its impact on inflation, and the implication of its refusal to fine-tune the economy. Third, we seek to evaluate the convergence and cohesion of the eurozone members, a primary condition for the favourable effects of monetary union. Finally, in a concluding section, we highlight the growing role of the euro in the international monetary system.

2.1 Stability and Growth

The Monetary Union was meant to create conditions of stability and stronger growth for the participating member states. More than a decade after the implementation of the euro, it is possible to strike a preliminary balance on the first realisations of the eurozone. The following charts show that in a wide range of areas, such as employment or growth volatility, the eurozone has performed better than in the previous decades.

Graph 1: Volatility of GDP Growth (standard deviation - 5 year rolling)



Source: European Commission

Looking at the volatility of GDP growth as a first indicator of stability, graph 1 illustrates that the growth of output seems to have been stabilised in the euro area since the end of the 1990's. Although the eurozone has not been the only area enjoying this decline in volatility of output growth, the convergence of economic policies of the eurozone countries coupled with a steady monetary policy of the ECB in its response to major events, such as the global economic downturn in the early 2000's, seem to have significantly contributed to achieving this decline. Moreover, one observes from the graph that the eurozone as a whole has been moving more in step with global business cycles.

Commentary — **Edmond Alphandéry**, Chairman of the Board of Directors, Caisse Nationale de Prévoyance (CNP), and Former French Economy Minister

"Graph 1 is very telling as it shows that the euro has reduced instability. About intra euro area imbalances, I think that government and (not the euro) are responsible for their increased divergence. Germany adopted wage discipline. On the contrary, some other countries because the balance of payments constraint had been removed did not pay attention enough to their loss of competitiveness and fell into a dangerous trap."

This increased stability partly compensates for the poor results in terms of real GDP and real GDP per capita; the respective percentage rate of change went from 2.2 to 2.1 for the real GDP and from 1.9 to 1.6 for the real GDP per capita, when the two periods before and after the creation of the Euro, are compared (Table 1).

Table 1: Macroeconomic Performance Indicators

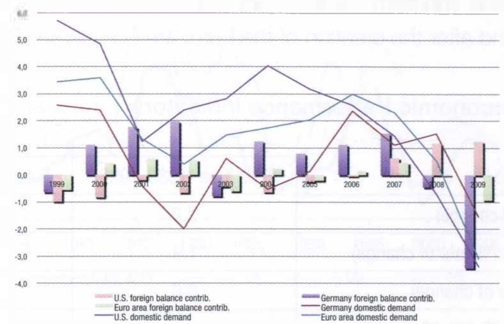
	Euro Area (1989-1998)	Euro Area (1999-2008)
Real GDP (% rate of change)	2.2	2.1
Real GDP per capita (% rate of change)	1.9	1.6
Employment (% rate of change)	0.6	1.3
Labour Productivity (% rate of change)	1.6	0.8
Unemployment (% of labour force)	9.3	8.3

Source: European Commission, OECD

A second achievement of the eurozone has been stronger growth in employment. As shown in table 1, the average employment growth rate went from 0.6% during the period 1989-1998 to 1.3% during the period 1999-2008. The increase in employment has been accompanied by a decline of the average unemployment rate from 9% in 1999 to an estimated 7% in 2008. The flipside of this development has been a sharp fall in productivity growth: in fact, the average year-on-year change in labour productivity growth has decreased from 1.6% for the period 1989-1998 to 0.8% during the period 1999-2008. This decrease seems to illustrate a trade-off between job creation and productivity.

"A second achievement of the eurozone has been stronger growth in employment. The average employment growth rate went from 0.6% during the period 1989-1998 to 1.3% during the period 1999-2008"

Graph 2: Domestic Demand (% change) and Foreign Balance Contributions to Changes in GDP (%)



Source: OECD Economic Outlook no. 86 (Nov 09)

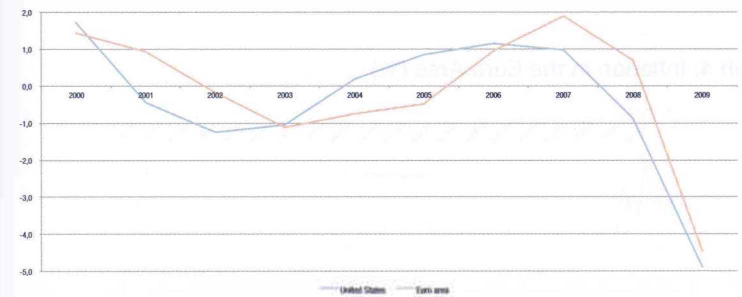
Regarding the eurozone's position in the world economy, it features an important export dependency, as graph 2 reveals. Nonetheless most economists agree that the performance of the last decade is due to positive external forces rather than homemade demand (Bibow, 2009). The recession of the 2000's has been followed by domestic demand weakness and a separation between domestic demand growth and net export contribution to GDP. The slow increase from 2002 may be related to the prospect of entry of the new member states from Eastern and Central Europe, to be followed by euro adoption.

This export dependency copies to a lesser extent one of the main characteristics of the German economy, whose traits may partly have been transferred to the eurozone via the Maastricht regime modelled on the German Bundesbank.

Since 1999, the eurozone has gone through a whole economic cycle, moving from its peak at the creation of the euro to its trough in the wake of the "dotcom bust", with slow recovery thereafter (EC, 2009a). The slow recovery represents one of the main features of the euro area, enjoying brief booms followed by a long period of stagnation (Bibow, 2009). This may be resulting from a relative lack of resilience of the eurozone in the face of shocks.

As shown in graph 3, the euro area needed a longer time period than the United States to recover from the downturn of the beginning of the 2000s, with longer negative output gap development.

Graph 3: Output Gap Developments after the Cyclical Peak of 2000 – Eurozone and U.S. (in %)



Source: OECD Economic Outlook no. 86 (Nov 09)

2.2 ECB's Monetary Policy

The Monetary Policy pursued by the ECB has been relatively successful in achieving its primary goal: maintaining price stability around the 2% threshold. As shown in table 2, the average rate of inflation for the period 1999-2008 has been 2.2%. Moreover, this rate of relatively stable inflation during the last decade follows a period of important changes of the inflation rate with a peak at 5% at the beginning of the 1990's. The ECB's 2% target has been seen as credible by economic actors and is well anchored in their expectations.

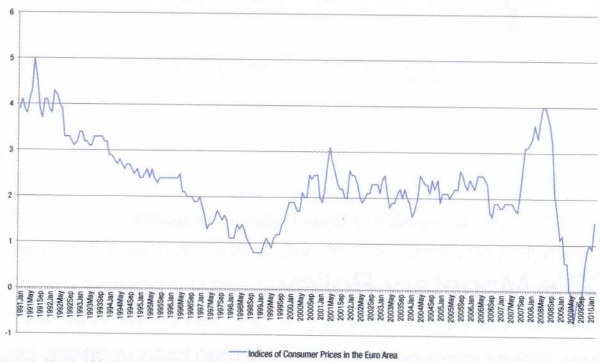
Table 2: Macroeconomic Performance Indicators cont.

	Euro Area (1989-1998)	Euro Area (1999-2008)
Inflation (%)	3.3	2.2
Real long term interest rate (%)	4.7	2.4

Source: European Commission, OECD

Graph 4 shows the inflation rates of the last two decades. One may argue that the "second pillar" strategy and the quantitative definition of price stability have not been fully respected with the inflation rates being above the 2% target at some periods in time. However the price stability appears to be greater than during past periods and economic agents continue to consider the inflation target as credible and build their inflation expectations upon it (EC, 2009a).

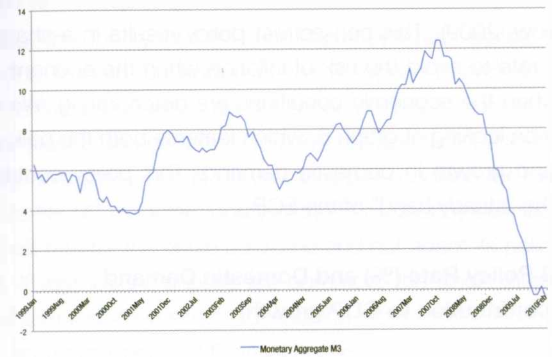
Graph 4: Inflation in the Euro Area (%)



Source: European Central Bank

Regarding the eurozone's position in the world economy, it features an important export dependency. Nonetheless most economists agree that the performance of the last decade is due to positive external forces rather than homemade demand

Graph 5: Broad Monetary Aggregate – M3 (% change)

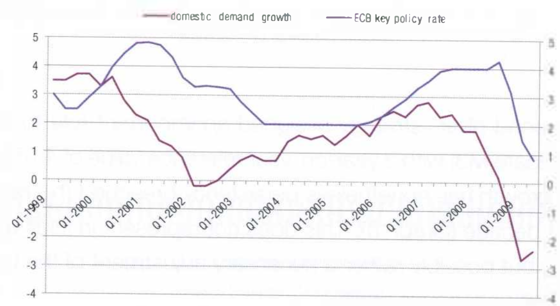


Source: European Central Bank

The ECB's "second pillar" strategy assigned an important role to broad money creation (Aggregate M3) with a year-on-year reference value of 4.5% growth. The broad money growth has nonetheless persistently breached this reference value during the last decade (Graph 5). This does not represent in itself a failure of the ECB's strategy but possibly rather a necessary adjustment of the target to allow for a better fit with economic reality.

The ECB's peculiar interpretation of its role, making price stability its primary and "de facto unique" goal, is translated into an outright rejection of fine-tuning the economy (Bibow, 2009). This non-activist policy results in a sharp increase of the key policy rate to avoid the risk of inflation when the economy booms and slow easing when the economic conditions are deteriorating. We can observe this phenomenon looking at graph 6, which features both the policy rate settled by the ECB and growth in domestic demand. This policy contributes to the reputation of the "steady hand" of the ECB.

Graph 6: ECB Policy Rate (%) and Domestic Demand (as contribution to GDP growth)

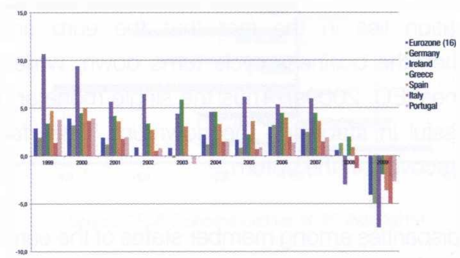


Source: Eurostat, ECB

2.3 Intra Euro Area Imbalances

As seen above, the theory of Optimum Currency Areas states that a primary condition for the smooth functioning of the European Economic and Monetary Union is that participant countries do not encounter big asymmetric shocks. Thus, they need their respective economies to converge and their business cycles to be increasingly synchronised. This is viewed as a pre-condition for the effectiveness of the "one-size-fits-all" monetary policy of the ECB, that by definition can only set a unique interest rate for the entire eurozone and not adapt its policies to national requirements. If asymmetric shocks are common, the single interest rate could engender counter-productive effects, deepening recessions in troubled economies while limiting growth prospects of flourishing ones.

Graph 7: GDP growth of some eurozone Countries



Source: Eurostat

A look at the track record of the eurozone reveals that the necessary convergence among member states toward the best performers has not taken take place during the last decade. The macro-economic stability, described above, hides intra-euro area imbalances with economic performances differing tremendously from one country to another. Indeed, when looking at the sole GDP growth rates of some of the euro area member states over the last decade (graph 7), one can notice the relatively weaker results of Germany and Italy, two of the largest countries in the euro area, in comparison to the average GDP growth of the eurozone.

On the other hand, the performance in terms of GDP growth, before the financial crisis, of three of the "cohesion countries", namely Spain, Ireland, Greece, has been stronger than the eurozone average rate, while Portugal's growth rate was disappointing.

This divergence deserves closer scrutiny. One explanation for these growth rate differentials may be the conditions under which the member states entered the euro area. In fact, some countries were still suffering from past disturbances and did not enter the eurozone under "steady state" conditions. For instance, Germany had to work off the consequences of the reunification, whereas Italy suffered from losses in competitiveness due to weak productivity growth and its particular industrial structure. In the case of Portugal, the country experienced poor fiscal management coupled with increased public expenditures that failed to boost the real economy (EC, 2009a).

A second explanation lies in the fact that the euro area enjoys strong synchronisation when the business cycle turns down, while lacking cohesion during recovery times (EC, 2009a). Thus the single monetary policy may have been more successful in stabilising the downturn, while failing to sustain a general economic recovery in the upturn.

Another source of disparities among member states of the euro area comes from their fiscal positions. While the eurozone enjoyed a decline of its fiscal imbalance, from -4.3% during the period 1989-1998 to -1.7% for the period 1999-2008 (Table 3), the individual member states did not all maintain themselves within the limits of the Stability and Growth Pact (year-on-year deficit of 3% of GDP).

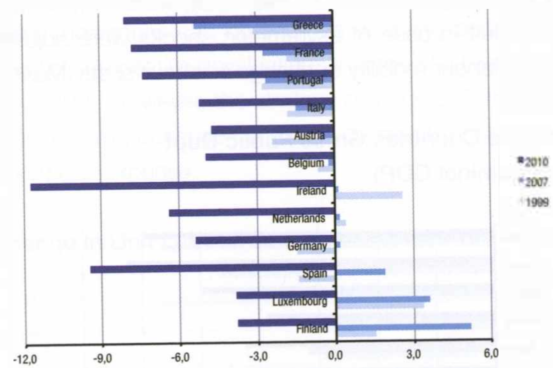
Table 3: Macroeconomic Performance Indicators cont.

	Euro Area (1989-1998)	Euro Area (1999-2008)
Fiscal Balance (% of GDP)	-4.3	-1.7
Gross public debt (% of GDP)	68.6	68.6

Source: European Commission, OECD

Graph 8 shows divergent financial balance positions across countries of the euro area. As one can see, several countries failed to maintain a medium-term budget "close to balance or in surplus". In fact, despite favourable economic conditions, most countries did not succeed in running a positive budget deficit in 2007. At the top of the graph, we observe that Greece breached the SGP limit, whereas France and Portugal ran a budget deficit close to 3%.

Graph 8: Eurozone Countries Financial Balances (% of nominal GDP)



Source: OECD Economic Outlook no. 87 (May 2010)

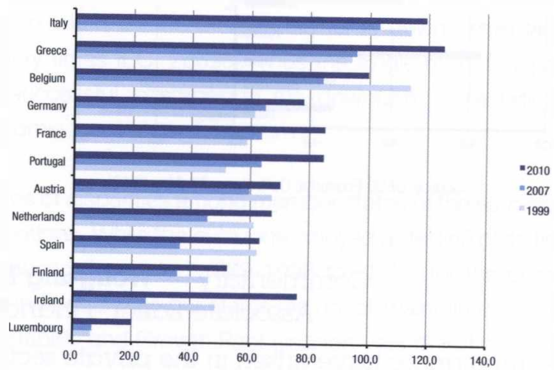
Commentary — **Wolfgang Münchau**, Associate Editor, *Financial Times*

"Most of the imbalances have arisen in the private sector, except in Greece. Germany and France have similar debt-to-GDP ratios. The overshoot in Ireland and Spain is due mostly to developments in the private sector or due to public-sector guarantees of the banking system, but these would not have been subject to the stability pact. It is thus not clear to what extent a new stability pact or any other measure to improve fiscal discipline would reduce overall imbalances."

Regarding public debt and the Maastricht treaty's target of a 60% debt-to-GDP ratio, the eurozone as a whole did not perform satisfactorily. Indeed, it ran the same average gross public debt from 1989 to 2008, with only two countries, namely Luxembourg and Finland that kept their public debt under the 60% threshold during the three time periods displayed in graph 9.

Finally, the most striking intra-eurozone imbalances concern competitiveness. In fact, despite the absence of nominal exchange rates in the euro area, a real exchange rate channel, reflecting differentials in price and wage evolutions, still exists. Robert Mundell pointed out in 1961 that, within a Monetary Union, the only mechanisms left in case of asymmetric shocks were adjustments in the labour market, i.e. labour mobility or change in labour costs (Mundell, 1961).

Graph 9: Eurozone Countries Gross Public Dept (% of nominal GDP)

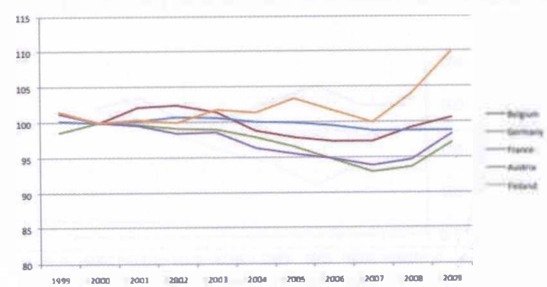


Source: OECD Economic Outlook no. 87 (May 2010)

As revealed in graph 10, Germany has improved its competitiveness in terms of changes in unit labour cost. This German wage deflation strategy may be interpreted as a "cyclical weakness" rather than resulting from an asymmetric shock (EC, 2009a), but the mechanism works like in the case described by Mundell: German companies became more competitive relative to their counterparts in other member states. Other countries, such as France and Belgium, maintained their competitiveness position *vis-à-vis* the rest of the euro area, while a third group of countries including Greece, Ireland, Italy, Portugal and Spain, suffered from a competitiveness loss.

These intra-area imbalances can be seen as worrying because they seem to reflect a strategy of competitive devaluations that the EMU was supposed to ban forever (Bibow, 2009). However, the strategy of wage deflation cannot work for the eurozone as a whole, because the gain in competitiveness is being achieved at euro area partners' expense.

Graph 10: Change in Unit Labour Cost (%)



Source: Ameco

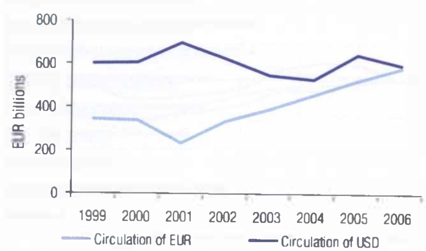
2.4 International Role of the Euro

"The euro is a major new pillar in the international monetary system and a pole of stability for the global economy" said Joaquín Almunia[1], former Commissioner for Economic and Monetary Affairs, and currently Commissioner for Competition. Indeed, during the last ten years, the euro has matched the dollar in the global economy in a wide range of areas, such as reserve positions or level of currency in circulation.

The worldwide use of the euro has seen a large increase since its creation in 1999, quickly becoming the second most important international currency alongside the U.S. dollar.

Graph 11 illustrates this upward trend, showing the increase of the amount of Euros in circulation from 2001 to 2006, nearly matching the levels of the U.S. dollar.

Graph 11: Euros and U.S. Dollars in Circulation (bn. euro)



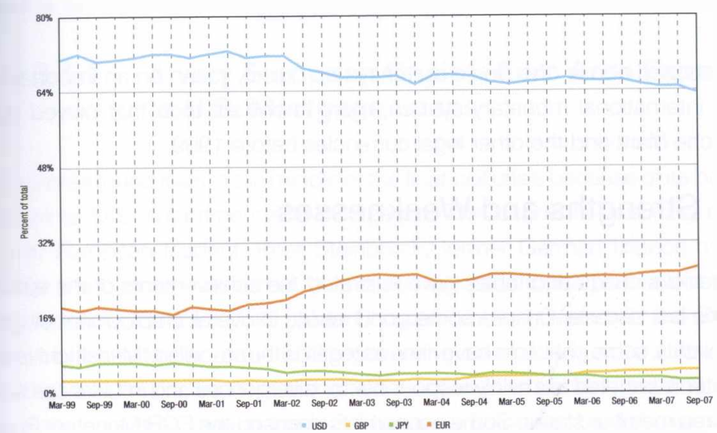
Source: ECB, FRB

1 Foreword to the European Commission's report *EMU@10: successes and challenges after 10 years of Economic and Monetary Union*, 2009, European Commission.

Moreover, the euro has come to represent a relatively important share in global foreign exchange reserves. As displayed in graph 12, more than 25% of disclosed reserves were denominated in euro by mid-2007, up from around 18% in 1999. In the meantime, the share of the U.S. dollar has suffered a decline from 71% to 65%.

The rise of the euro as an international currency is confirmed by its increasing use as an exchange rate anchor. Indeed, the euro is currently used as reference currency in several countries, including Croatia, Albania, Morocco and Tunisia. This role of the euro is influenced by historical, economic or political links, and is thus limited to certain regions.

Graph 12: Currency Shares in Global Foreign Exchange Reserves



Source: IMF, COFER

Despite the depreciation of the euro against the U.S. dollar in the early 2000's, its exchange rate *vis-à-vis* other key currencies has appreciated well beyond its fundamental value. In fact, at its peak in 2009, the euro reached nearly 1.6 U.S. dollars, which was well above its exchange rate at its launch in 1999.

Graph 13: Exchange Rate Euro/Dollar

Source: European Central Bank

As described above, the single currency has quickly taken on an important role in the international monetary system, more important than that played by the Deutsche Mark and the other legal currencies before 1999.

2.5 Strengths and Weaknesses

The previous charts and tables have illustrated the achievements of the eurozone over the last decade. Despite some good results in overall employment or growth rate volatility, some concerns have risen as regards the so-called "Maastricht regime". The latter is targeted as mainly responsible for divergences and imbalances among euro area member states. Some economists accused the ECB Monetary Policy of spreading the "German disease" (Bibow, 2009), resulting in a collapse of domestic demand. Moreover, the results in terms of inflation rates have crossed the 2% target several times during the last decade, resulting from a counterproductive interaction between ECB's monetary and member states' fiscal policies (Bibow, 2009). In fact, some member states, threatened by excessive deficits, increased indirect taxes to keep their fiscal balance within the limits of the Maastricht criteria, which had the effect of pushing up headline inflation.

3 Responding to Pressure

3.1 Impact of the Global Crisis

The performance records shown above reflect the stance of the euro area before the financial crisis hit Europe. This global downturn constitutes the first real test for the eurozone and illustrated its capacity to react under pressure. For a long time, euro area political leaders refused to face reality and resisted calls from the IMF for measures to limit the consequences of the subprime mortgage crisis that originated in the United States (Wessel, 2008). In fact, the eurozone got severely hit by the global crisis through its banking exposure to the U.S. subprime mortgage sector. Moreover, the collapse in demand and capital flows worsened the situation and increased the consequences for euro area countries.

3.1.1 A very European Crisis – Euro Area Exposure to U.S. Mortgage Loans

The euro area found itself in the middle of the financial crisis because of its banking exposure to U.S. subprime credit mortgages. This exposure was long denied by most European leaders. Peer Steinbrück, former German finance minister, said after the Lehman failure that "this crisis originated in the U.S. and is mainly hitting the U.S." (Benoit, 2008), while Christian Noyer, governor of the Banque de France and member of the ECB's governing council, argued in a speech in April 2008 that "major financial disruption (involving the banking system) is less likely in the euro area than in the U.S." because European banks' exposure to U.S. mortgage subprime "is on average significantly lower than that of their U.S. counterparts and their model of universal banking allows them to mitigate the consequences of a crisis in one segment of their activity" (Noyer, 2008). This turned out to be wrong and seems to have delayed the ECB reaction to this shock. In reality, the euro area, as well as some private investors, appeared to be considerably exposed to U.S. toxic assets. Both were attracted by the higher yields offered by the mortgage credit segment. In fact, European banks directly acquired subprime mortgage loans, or purchased financial derivatives such as Mortgage Backed Securities (MBS) or Collateralized Debt Obligations (CDO). These derivatives were either held directly on the banks' balance sheets or through a variety of conduits and Structured Investment Vehicles (SIVs). The following table reveals the exposure of European and U.S. Banks to U.S. Subprime Mortgage Market before the peak of the current crisis.

Table 4: Bank Exposure to U.S. Subprime Mortgage Markets (calculation as of March 2008)

	European Banks		U.S. Banks	
	Level (bn. dollars)	Share (%)	Level (bn. dollars)	Share (%)
Subprime mortgage loans	106	38	190	50
Subprime mortgage-related MBSs	85	30	40	10
Subprime mortgage-related CDOs	88	32	151	40
Total exposure	279	100	381	100

Source: IMF. Regional Economic Outlook: Europe

At the European level, this corresponds, according to the IMF's calculation, to an exposure to U.S. subprime mortgages for European banks of roughly 73% of the exposure of U.S. banks. Moreover, in recent years, many of those European banks became highly leveraged, which left them with little room for manoeuvre when credit conditions worsened and they had to face important write-downs (FT, 30/09/08). Table 5 sums up reported and expected losses of European and U.S. banks, as calculated of March 2008. One can see that overall expected losses in billion dollars for Europe are relatively close to the U.S., even though the exposure to different financial products is different, with Europe relatively more exposed to Mortgage Backed Securities and Special Investment Vehicles than the U.S. (IMF, April 2008). Europe's isolation from the crisis turned out to be an illusion.

The aggregate losses for European banks hide situations that differ tremendously between countries in the euro area. Indeed, while the banking sector of some countries, like Germany, the Netherlands or Belgium, has been severely hit and calls for financial assistance arose (described below), relatively, banks of

other member states had been focusing more on traditional banking operations and had been concentrating on their core market which usually reduced their exposure to toxic assets.

Table 5: Estimated Losses on Mortgage-related Subprime Bank Exposures (bn. dollars)

	Europe	U.S.
Expected losses	123	144
U.S. Subprime loans	16	29
MBSs	27	12
CDOs	53	90
Conduits and SIVs	27	13
Reported losses*	80	95

Source: International Monetary Fund, Regional Economic Outlook: Europe
*Calculation as of March 2008

In Germany, banks did not conduct significant retail operations in the U.S. (with the exception of Deutsche Bank AG, the country's leading institute, that in spite of its reliance on retail operations suffered less than other large German banks). Yet many of them, especially the public Landesbanken, that were supposed to fund the regional economy, turned out to be exposed to important risks and were severely hit because of the accumulation of risky financial mortgages assets on their balance sheets (Fitch Ratings, 2007). Those financial derivatives exposed a large fraction of the German banking sector to considerable threats and obliged the German federal government to intervene. The intervention took the form of a bail-out, first of Sachsen LB and IKB, then BayernLB, HSH and Nordbank, a nationalisation of Hypo Real Estate, and finally the set up of a so-called "bad bank", which took over toxic assets from WestLB (Tait, 2009).

The risks borne by French banks in regard to their exposure to the U.S. subprime market happened to be relatively small and have been largely mitigated by these banks' large equity base, sounder business diversification and a stronger deposit base (Fitch Ratings, 2007). This explained the relatively smaller state intervention, limited to capital assistance and debt guarantees for the Benelux institution Dexia and its subsidiary FSA, together with Belgium and Luxembourg.

The Benelux banking in general suffered more severely from the financial turmoil, mainly in an indirect manner through important international activities in MBSs and CDOs, as well as via SIVs and conduits. In the Netherlands, the most affected banks were NIBC Bank N.V., ABN AMRO and ING Group. In Belgium, Fortis Bank was nationalised and partly sold to BNP Paribas.

The banks of other eurozone countries such as Spain, Italy or Portugal had smaller exposure to U.S. subprime assets, a situation that was similar in Nordic countries, as well as in Greece.

3.1.2 Collapse on the Demand Side

Beyond the banking sector crisis, some euro area economies have been further destabilised by the subsequent crash of the real economy and real estate markets, as well as the collapse of world trade. Considering the important linkages between EU countries through the single market, negative feedback loops quickly spread these effects across other member states of the eurozone and amplified troubles (Bibow, 2009).

The Spanish high economic growth of the past few years had been relying on huge spending in the building sector, with average prices of houses having doubled since the year 2000. The pre-crisis evolution had been triggered by low interest rates and willing lenders, with credit to property growing more than 40% per year from 2005 to 2007 (FT, 24/04/07). Moreover, property ownership had been boosted by rising incomes over the last decade and demographic growth due to high immigration.

Conditions for a bubble emerged and the latter had been growing year after year till the beginning of 2007. In April 2007, the first shock came from the stark fall in the stocks prices of some major construction companies, with Astroc, leading real estate agent, going down by 70% over a week's time.

The Spanish stock market reflected worries about the future of the construction sector. One reason for this was the oversupply of new housing, with 800 000 new houses for 2007, compared with estimated demand of 600 000. Moreover, the sector's reputation had been damaged by several corruption scandals linked to real estate transactions (Crawford, 2007).

Domestic demand crashed severely and hit the banking sector, the latter being relatively preserved from the U.S. toxic assets but exposed to the risks from the domestic housing sector. Spain's banks and cajas (i.e. unlisted savings banks) were exposed to the collapse of property developers and construction companies. After their collapse, property projects were handed over to creditors, but their values had shrunk and turned them into poor-quality debt for the banking system. For instance, the collapse of Martinsa Fadesa, one of Spain's biggest developers, was partly responsible for a €9bn. surge in overall bank bad debts in July 2008. And the situation continued to worsen with many more of those corporate loans turning bad. Some analysts estimate that a third of the lending to property developers (estimates range from €40bn. to € 90bn.) could go bad before the slump ends (Victor Mallet, 2008).

Spain seems slowly headed for a painful adjustment, with a need for greater efficiency and reduced demand, which will inescapably lead to recession and growing unemployment, according to Dominic Bryant, economist at BNP Paribas (Chris Giles, 2009).

Just as in the case of Spain, Ireland's exposure to the U.S. mortgage credit sector and other toxic assets was minimal. But, the country had attracted financial institutions from around the world through a very favourable business environment and namely, low tax rates. The huge share of the banking sector in the Irish GDP made the entire economy vulnerable to shocks in the financial sector. In addition to this vulnerability through its banking sector, the country suffered from a housing bubble that burst in 2007. Ireland had been overly dependent on housing for maintaining its budget and boosting growth. Indeed, at the peak of the housing bubble, residential investment accounted for 13% of Irish GDP while capital gains tax and stamp duty accounted for 13% of Irish tax revenues (Sutherland, 2009). When the bubble burst, the former Celtic Tiger faced a sharp decrease in its tax revenue and its economy slowed down relatively quickly. Some voices in Ireland attributed the country's economic difficulties to its membership in the euro area. However, the problems that Ireland was facing are not fundamentally linked to Economic and Monetary Union membership. Most likely, the housing boom and burst would have occurred even if Ireland had stayed outside the eurozone. This is illustrated by the fact that many peripheral countries outside the euro area which had experienced similar trends in credit increase over the last decade, mainly due to low interest rates and a significant decrease in risk aversion (Lane, 2009a), suffered from similar developments.

Besides the fatal impact of bursting housing bubbles, the collapse of world trade hit the European economy, with the most severe impact on the most export-oriented economies. Germany for instance suffered, beyond its exposure to U.S. toxic assets, from a sharp decline in foreign demand due to the depression of key EU export markets, which proved disastrous given her export-dependency. The decline in world trade following the global crisis depressed Germany's growth engine and amplified the consequences. Germany is currently trying to push its way out of the crisis by increasing its exports again. Despite a certain success of this revival of the pre-crisis model, criticism in and outside the EMU is growing. The OECD, for instance, warned in a recent report that the country should refrain from relying only on its export engine to boost its recovery (Atkins, 2010). Indeed, in its Economic Survey on Germany, the organisation said that the challenges for Germany "were to ensure the continued high performance of the export sector and broaden this performance to the other sectors of the economy". This should be done through increased flexibility and attractiveness of the country's domestic economy and would moreover help reduce intra euro area imbalances (OECD, 2010).

As described above, the eurozone was severely hit by the global crisis with consequences varying considerably between member states. However, this crisis, originating in the U.S. mortgage credit sector, did not hit Europe as a genuine external shock. In fact, the member states banking sector increased their exposure to toxic assets over the last decade, being attracted by higher yields. Europe acted as an amplifier of the global collapse (Bibow, 2009). The high exposure of the financial sector of certain member states called for state

intervention via capital injections and/or guarantees for bank liabilities. Thus, the bank risk has been transformed into sovereign risk (IMF, April 2008) and, as European Central Bank Executive Board member Jürgen Stark put it, the euro area and other industrialized nations may have entered a sovereign debt crisis (Stark, 2010).

3.2 Fiscal and Monetary Responses

3.2.1 The European Economic Recovery Plan

As shown above, Europe has been hit hard by the crisis that its leaders had initially perceived as being merely an American problem. Once the scope of the downturn became apparent, the implications could no longer be ignored and action was taken across Europe. In December 2008, the European Council approved the European Economic Recovery Plan (EERP), which aims at coordinating the EU's response to the crisis and encourages member states to choose from a range of revenue and expenditure options according to their specific needs. The aggregate budgetary measures represent a total of €200bn. (EC, 2009b).

In addition, the EU budget contributed to the stimulus package via accelerating payments accounting for €6.3bn. under the structural and social funds, as well as €5bn. (using unspent money from the EU budget) to improve energy interconnections and broadband infrastructure. Even though it is regarded as "new money", experts say that the EU commitment cannot be expected to have a strong impact on the path of recovery (Begg, 2010a). First, the total amount is relatively small. Second, the budget is dominated by multi-annual programmes (e.g. regional funds), which give limited scope for flexibility. Moreover, the EU budget comprises mainly member states' transfers and a call for an increase in spending would be currently unthinkable.

To ensure the effectiveness of the EERP, the fiscal measures proposed were designed to fulfil four broadly accepted criteria of fiscal theory. They must be "timely, temporary, targeted, and coordinated" (Sylvester & Eijffinger, 2010).

However, not all member states participated in the EERP because of different fiscal situations, giving a different margin for manoeuvre.

The gross aggregate fiscal stimulus for all 27 member states accounted for 1.4% of GDP in 2009, and is expected to increase further by 1.3%. The automatic stabilisers are estimated to have an aggregate effect of 3.2% of GDP over the period 2009-2010, so that the total fiscal stimulus from national sources would be around 5% of GDP, once the offsetting effects of fiscal consolidation measures adopted by a number of countries are taken into account (EC, 2009b).

3.2.2 Overview of National Stimulus Packages in some Euro Area Countries

The measures taken by most member states pursue four principal aims: boosting the purchasing power of consumers, increased spending on the labour market, reducing taxes and social security contributions, and increasing public investment (Begg, 2010a). However, given that the effects of the crisis on the EU member states vary tremendously, the national measures adopted to counter the down-turn also give a heterogeneous picture.

As the EU's largest economy, **Germany** has implemented the largest eurozone stimulus package in absolute terms, with budget consequences of about 3.3% of GDP. The stimulus package comprises a vast range of measures to support purchasing power (2.1% of GDP), with income tax cuts, support for low-income households and special designations for families. The German federal government also targeted, to a lesser degree, the labour market, with schemes for subsidised short-time working and reimbursement of employers' Social Security contributions. Some additional efforts have been made towards private businesses, with research and development loans, tax credits and credit guarantees for SMEs. This large fiscal stimulus may be viewed as a partial compensation for its long-standing export-oriented policy, strongly benefiting from disappearance of the nominal exchange rate and thereby reinforcing imbalances within the eurozone through increased exports.

France, in comparison, has adopted a smaller fiscal stimulus package. The latter focused mainly on investment projects in the automobile, construction and maintenance sectors, accounting for 0.4% of GDP. Other measures, such as low-income households' support and reduced employers' Social Security contributions focusing on job creation and short-time working, have been implemented following the German example. The total fiscal stimulus accounts for 1% of the GDP, which is small compared to other eurozone members, but may be explained by the fact that France's budgetary policy over the last decade had provided large support to euro area domestic demand.

The Netherlands' fiscal stimulus accounts for about 2% of its GDP, with major contributions in public investments towards the housing market and infrastructure. Some more measures have been taken to encourage domestic demand, especially dedicated to low-income households and families with children. The country is also supporting businesses with guarantees of 50% of company loans up to € 50bn.

Italy did not provide important support to its economy because of its already high level of public debt. The few measures that have been taken were designed to be deficit-neutral and comprise tax breaks for low-income households and delaying value-added tax payments to companies.

Spain has put forward a quite substantial stimulus package, accounting for 1.4% of its GDP. The largest part of the plan is dedicated to public infrastructure (about 0.9% of GDP). In order to support purchasing power, the Spanish government has extended housing construction support, provided for income tax deduction, and abolished the wealth tax. However, the country is planning an early reversal of the fiscal stimulus due its worsening public finances.

According to the June 2009 Commission paper on the *Progress on the implementation of the European Economic Recovery Plan* a quarter of the stimulus packages contributed to "a more innovative, knowledge based, low-carbon economy" (EC, 2009b). This illustrates the particular attention devoted to environment-friendly initiatives and investments in the member states' fiscal stimulus. Among those initiatives, one can mention Spain's stimulus package, which includes €600m for sustainable tourism, or Germany's package with €2.8bn. for carbon-friendly renovation of houses. Moreover, most countries included car-scrappage schemes that encourage the replacement of old cars with more energy-efficient modern ones.

Most economists agree that discretionary public spending has a stronger effect than tax cuts since, during a crisis, consumers' propensity to save tends to be much higher than their propensity to consume. Nonetheless, tax cuts could have a substantial effect if they are limited in time in order to avoid neutralising anticipations of large increases in the future (EC, 2009b).

3.2.3 The ECB's Response – Monetary Policy since the beginning of the Crisis

The ECB did not repeat, to a large extent, the mistakes that its predecessors made when facing the Great Depression (De Grauwe, 2010a). Indeed, among the lessons of the 1930's, the most important was that central banks should be ready to provide substantial liquidity to ensure the functioning of the banking sector and this is exactly what the ECB did from the beginning of the financial crisis. As early as August 2007, the ECB provided liquidity to the banking system through a fixed-rate operation with full allotment, amounting to €95bn. within a few hours (Trichet, 2009).

During the following months, the ECB pursued the goal of guaranteeing that households and companies could access credit in order to preserve the viability of the banking system as a whole. The policy response took the form of so-called non-standard measures, including significant liquidity diffusion, qualitative easing, and an increased number of counterparties eligible for refinancing with the ECB.

The first non-standard measure implemented by the ECB, in order to ensure larger liquidity diffusion, was a switch to so-called fixed-rate full allotment tender procedures. In normal times, the ECB auctions a given amount of Central Bank credit, mainly in refinancing operations, and competition among financial institutions further determines the interest rate. During the financial crisis, the ECB turned this practice around. The Central Bank started to determine the lending rate (at a low level) and supplied liquidities demanded at this interest rate. Moreover, although the normal-time refinancing operations have a maturity of one week, during the crisis the ECB expanded the maturity of its operations to up to six months.

Secondly, the ECB pursued a so-called qualitative easing monetary policy. In fact, the Central Bank extended its list of assets accepted as collateral to a wider range of securities. The total value of these securities was worth €12.2 trillion in 2009. This amounts to 86% of all debt securities issued in euros and to 130% of the euro area GDP. Among the overall amount of securities accepted as collateral by the ECB, government securities account for 44% of their nominal value, the rest being private securities. This vast eligibility of collateral had a strong effect in easing the banks' liquidity constraints during the crisis (Trichet, 2009).

Third, this unlimited supply of liquidity against a vast range of collateral could ease the banking system provided that the credit institutions that need it the most are given the opportunity to refinance themselves through the ECB. Thus, by changing its operational framework, the ECB increased the number of counterparties fulfilling all relevant criteria from 1700 before the crisis to 2200 in 2009.

Commentary — **Daniel Daianu**, former Romanian Finance Minister and former Member of the European Parliament

"Late in 2008 European leaders continued to be under an illusion of the relative robustness of EU economies. They seemed not to realise the extent of the involvement of EU-based banks in the origins and distribution of toxic financial products, the interconnectedness of financial markets, and the presence of shadow banking in Europe.

Nowhere is structure more significant than in the European Union. Here, massive cross-border operations take place while national prerogatives as regards regulation and supervision in tax policies remain essentially in national hands. The current crisis has revealed the antiquity of existing arrangements. The latter have favoured the accumulation of internal imbalances against the background of one-sided policy tools."

This enhanced credit support approach has been completed by the ECB's interest rate cut, which first occurred on 8 October 2008, following an international policy decision of central banks to reduce key rates. The ECB interest rate stayed slightly higher than that of other important central banks, namely the Federal Reserve and the Bank of England. Another difference with its U.S. and UK counterparts has been the refusal of the ECB to integrate exchange rate objectives in its monetary policy.

"The first lesson one can draw from the crisis is the lack of cross border financial supervision. The crisis was not only due to market failures, but was also the consequence of deep institutional shortcomings"

In fact, the U.S. and the UK have increased their supply of currencies (i.e. through so-called quantitative easing) much further than the ECB, eventually flooding their respective markets. Indeed, the U.S. Federal Reserve and the Bank of England doubled the size of their balance sheets since 2008, while the ECB's balance sheet increased by less than 50%. The consequence has been a devaluation of the pound and the U.S. dollar in comparison to the euro. This "economic orthodoxy", letting the foreign exchange market decide on the exchange rate, could eventually translate into slower recovery for the eurozone compared to the U.S. or UK (De Grauwe, 2010a).

3.3 Problems and Weaknesses in Policy Structures

3.3.1 Lack of Cross Border Financial Supervision

The first lesson one can draw from the crisis is the lack of cross border financial supervision. The institutions in place not only failed to anticipate the crisis, but also failed to understand and manage its consequences in time. In fact, this is true on both sides of the Atlantic, with neither the U.S. nor the EU having effective tools to manage the cross-border financial crisis. Thus, the crisis was not only due to market failures, but was also the consequence of deep institutional shortcomings.

As shown above, the Maastricht regime leaves financial supervision, to a large extent, at the discretion of the member states. This creates important distortions between wholesale markets that have become closely integrated, giving birth to an odd asymmetry between cross-border financial conglomerates on the one hand, and national supervisors on the other. Thus, large individual banks were threatening the existence of the whole banking system. Those big banks were not only "too big to fail" but also "too big to manage", and eventually "too big to save" for a single member state (Lamandini, 2010).

The crisis highlighted the failure of financial supervision bodies to gather and pool all relevant information on cross-border systemic risk, which in turn played a major role in the development of the crisis. These macro-prudential inefficiencies stem from the European fragmentation of "supervisory styles" (CEBS, 2009). Indeed, the eurozone is characterised by a wide range of supervisory models, based upon very different economic approaches. Among the differences, one can quote the Spanish model characterised by a system of "permanent exam", differing from other member states' models based upon ex-post exam (i.e. supervision rests on data sent regularly by the national banks). These differences in financial supervision at the member states' level make macro-prudential supervision a very difficult task.

The divergent regulatory standards and uneven supervision practices across member states not only eventually translated into a failure to prevent the crisis, but also hindered the supervisors' ability to effectively address the latter's effects. Indeed, most decisions regarding bank bail-outs were taken at the member state level. This turned out to be very inefficient. The most prominent example was the case of Fortis bank, which resulted in splitting up and bailing out the bank along national lines. A second example is the above-mentioned case of "too big to save" banks, when small member states eventually realised they were unable to bail-out large banks whose balance sheets were several times as large as their GDP.

Moreover, the doubts over some eurozone member countries' capacity to bail-out their banks reduced market confidence which increased the refinancing cost for these weaker member states. Thus, the bank risk turned into sovereign risk, and raised the question of the default of some weaker countries (Stark, 2010).

3.3.2 Lack of Fiscal Policy Coordination

As described above, the fiscal packages adopted by the eurozone member states differed substantially in scope and content. Even though they were implemented respecting the measures of the European Economic Recovery Plan, they still lacked cohesion. The composition of the different national packages varied from one country to another, with Spain for instance, privileging public investments in infrastructures, or Germany focusing on measures aimed at stimulating its domestic demand through income tax cuts.

Moreover, fiscal packages did not fully reflect the capacities of member states. In fact, even though Germany has implemented the biggest fiscal stimulus package, accounting for 3.3% of its GDP, the country recovery strategy still heavily depends on its exports engine, which amounts to relying on the stimulus packages of its key trade partners.

And when the fiscal stimulus packages target specific sectors, nationalist instincts quickly triggered protectionism and thus weakened the Single Market. Indeed, the measures aimed at the automotive industry accounted for a significant part of most national packages and were among those that tended to be relatively protectionist. This lack of cohesion between the national packages within the limits drawn by the EERP has diminished the impact for the euro area as a whole.

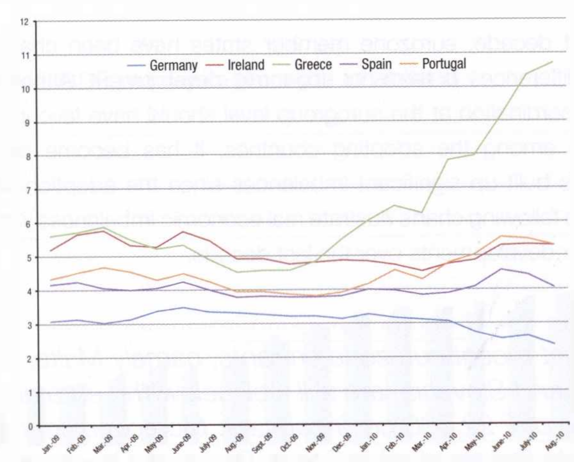
The failure to coordinate fiscal stimulus at EU level has highlighted the lack of instruments within the eurozone to deal with intra-area imbalances. The euro is a monetary union, but not a political union. In this regard, the euro lacks shared funding facilities. During the crisis, the ECB has fulfilled its role in providing liquidity to the market, but only a Treasury could tackle genuine solvency issues. The absence of bail-out mechanisms prevents eurozone member states from helping a member state which encounters difficulties.

Greece provides a striking example of the lack of instruments in the eurozone to address solvency problems. The country has been under fire from speculative attacks because markets expressed doubts about the eurozone's ability to sustain its weaker member states.

Over the last twelve months, Greek government bonds yield has constantly increased (Graph 14), except for a small decline in March 2010, following the eurogroup's commitment to create an emergency financial support facility for Greece. The EU/IMF bail-out package worth €110bn. was activated in May 2010 and resulted in a temporary slowdown of Greek bonds yield, but it rapidly increased again to reach more than 10% in July 2010.

Graph 14 displays government bonds yield of three other eurozone member states, namely Ireland, Portugal and Spain. Germany serves as a benchmark to evaluate the credit worthiness of these other countries, as well as Greece. The yield spread of German bonds over Greek bonds was about 8% in August 2010, reflecting the significant difference in sovereign risk between the two eurozone member states (Barrios, Iversen, Lewandowska, & Setzer, 2009).

Graph 14: Secondary Market Yields of Long-term Government Bonds (%)



Source: ECB

4 Coping with Imbalances

The present section intends to give an overview of existing imbalances within the eurozone. The first sub-section demonstrates the real and financial imbalances among member states, while the second sub-section articulates the eurozone's lack of instruments to coordinate policies and redress these imbalances. As revealed by the latest developments of the financial crisis, accumulated intra-euro area imbalances exposed some economies more than others to shocks and aggravated the consequences.

4.1 Tensions between strong and weak eurozone members

4.1.1 Real Imbalances

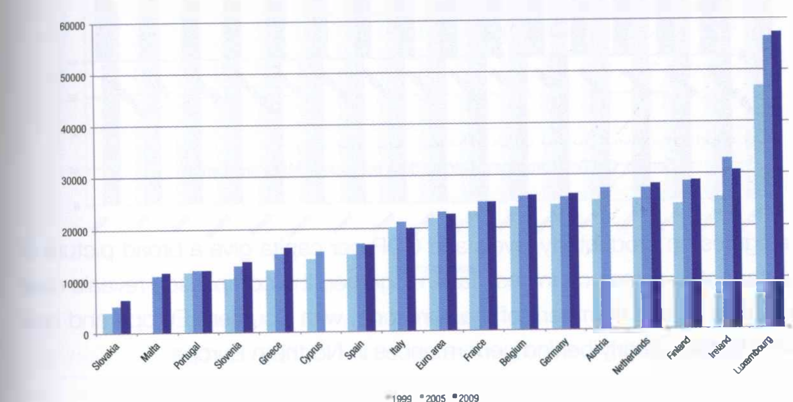
Over the last decade, eurozone member states have been characterised by substantial differences in terms of economic development. Although the euro and policy coordination at the eurogroup level should have favoured economic convergence among the adopting countries, it has become clear that the eurozone has built up significant imbalances since the adoption of the single currency. The following charts illustrate real economic imbalances within the euro area and their developments over the last decade.

"The most recent eurozone entrants, namely Malta, Cyprus, Slovakia and Slovenia, are still well below the euro area GDP average of € 22,600 per inhabitant. Moreover, countries in Southern Europe, that is Spain, Portugal, Greece and Italy, have not yet converged towards North European standards"

First, member states differ in terms of incomes levels, as measured by real GDP per capita. The latter ranges from €6,300 per inhabitant in Slovakia to €57,300 in Luxembourg for the year 2009 (Graph 15). As a measure of the economic activity in an economy, the GDP per capita levels reveal important differences across member states. The most recent eurozone entrants, namely Malta, Cyprus, Slovakia and Slovenia, are still well below the euro area GDP average of € 22,600 per inhabitant. Moreover, countries in Southern Europe, that is Spain, Portugal, Greece and Italy, have not yet converged towards North European standards.

"When comparing the levels within the eurozone, one notices that differences in terms of productivity among member states are tremendous, ranging from below €30 per hour worked in Slovakia, Slovenia, Portugal and Greece to almost €50 per hour worked in France, Netherlands, Belgium and Ireland"

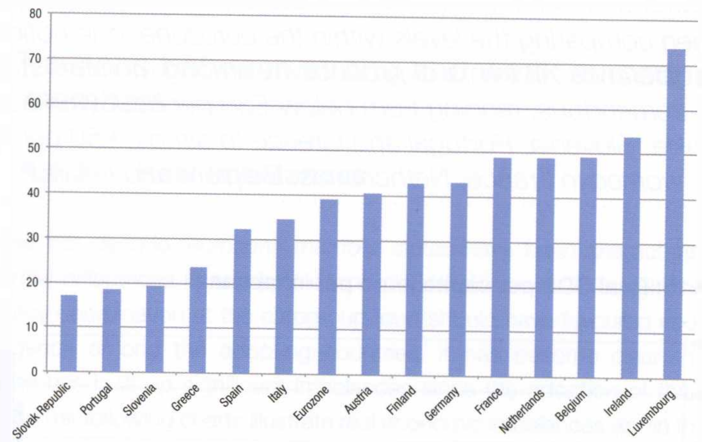
Graph 15: Real GDP per capita (euro per inhabitant)



Source: Eurostat

Considering the GDP per hour worked, Graph 16 shows a similar dispersion. The GDP per hour worked is intended to give a picture of the productivity of national economies. When comparing the levels within the eurozone, one notices that differences in terms of productivity among member states are tremendous, ranging from below €30 per hour worked in Slovakia, Slovenia, Portugal and Greece to almost €50 per hour worked in France, Netherlands, Belgium and Ireland.

Graph 16: GDP per hour worked in 2008 (euro)

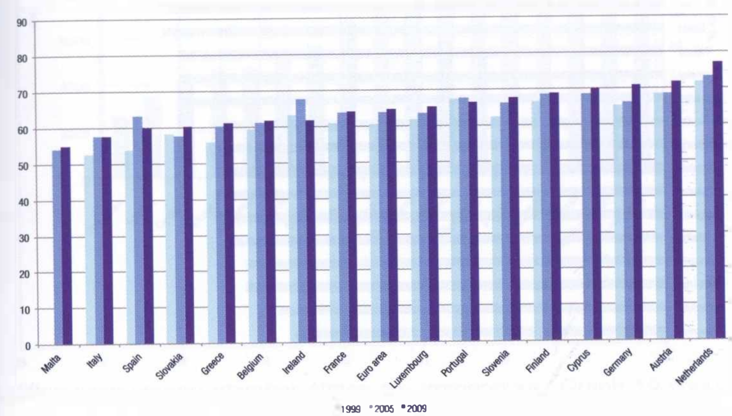


Source: OECD - (Eurozone's average does not include Malta and Cyprus)

These figures on productivity levels and GDP per capita give a broad picture of living standards across countries. Taken together, the comparison reveals clear divergences across members of the eurozone, with Southern Europe and new entrants lagging clearly behind performances in Northern Europe.

Turning to employment levels, estimates from the EU Labour Force Survey show that most member states feature employment rates between 60% and 70%, albeit there are three major exceptions (Graph 17). On the one hand, the Netherlands is characterised by a particularly high employment rate, which is partly explained by the fact that the country has the highest share of part-time jobs in the EU (Auer, 2000). On the other hand, Malta and Italy are characterised by employment rates below 60% (respectively 54.9% 57.5% in 2009). In the case of Malta, this relatively low employment rate is mainly due to low female participation, lying well below the EU average (Caruana, 2006). A specific feature of the Italian employment market is the striking regional disparities between the prosperous North and the less developed South, having a negative impact on the overall picture.

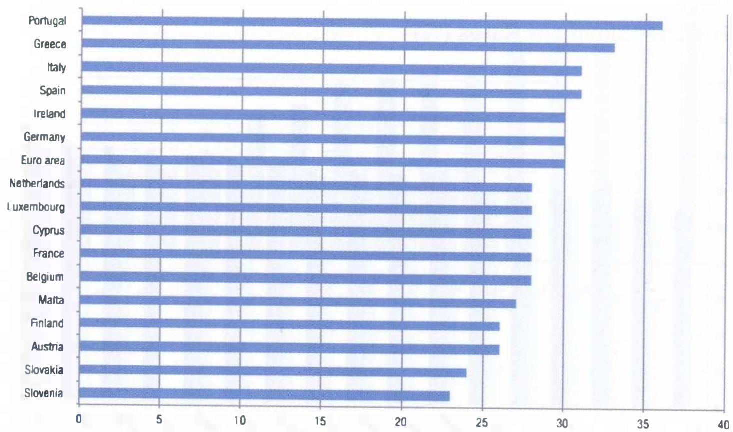
Graph 17: Employment Rates (%)



Source: Eurostat

With regard to income distribution, one can resort to the Gini coefficient, which gives measures of statistical dispersion in a given population. The coefficient can range from 0 to 100, with 0 corresponding to complete equality and 100 to complete inequality. In 2008, the average Gini coefficient for the eurozone was 30. This indicates a relatively low level of inequality by international standards. What is more, the euro area appears relatively homogeneous in this regard, with most member states featuring a Gini coefficient between 25 and 30 (Graph 18). The relatively more unequal countries are Spain, Italy, Greece and Portugal, while Slovenia and Slovakia, with a Gini coefficient below 25, are the most equal (respectively 23 and 24).

Graph 18: Gini Coefficient in 2008 (x100)

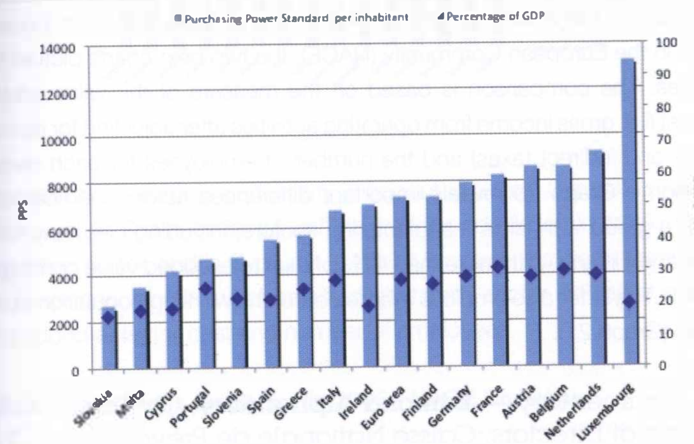


Source: Eurostat

When looking at the social protection expenditures in terms of GDP, one observes a relatively similar picture, with total expenditures as a percent of GDP ranging from 16% in Slovakia to 30.5% in France, for a eurozone average of 27%. There are, however, two major exceptions, namely Ireland and Luxembourg. The former is characterised by relatively low social protection expenditures per inhabitant (€7,054) accounting for 18.9% of GDP, well below the euro area average.

In addition to income levels, we analyse the extent of social protection by looking at differences in related expenditures across member states. The expenditures on social protection contain both the social benefits to households by relieving them of the burden of a defined set of risks or needs (through transfers in cash or in kind), and the administrative costs inherent to the management of the system.

Graph 19: Total Social Protection Expenditures in 2007 (PPS per inhabitant and % of GDP)



Source: Eurostat

The differences among member states are tremendous. Graph 19 shows that in 2007 government expenditures vary from 2,675€ per inhabitant in Slovakia to 13,231€ in Luxembourg. The estimates are expressed in Purchasing Power Standards (PPS) per inhabitant in order to eliminate the differences in prices between countries. Once more, we notice that the eurozone is divided between Southern countries, characterised by relatively low social protection expenditures, and Northern countries, with generous social protection systems.

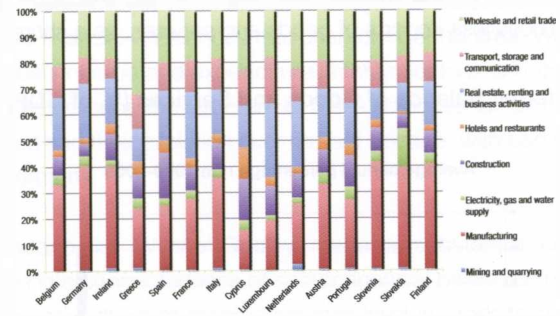
A historical reason for this low rate of social expenditures is the influence of the British welfare model on the construction of the Irish system (Timonen, 2003), resulting in low social protection expenditures as a share of GDP (e.g. 14.6% in 1999 - Table 5 in Appendix B). The second exception is Luxembourg featuring the highest social protection expenditures per inhabitant (€13,231), which accounts, however, for a relatively low share of its GDP (19.3%) reflecting, to some extent, its very high per capita income.

A further relevant indicator of divergences within the eurozone is the industrial structure of the eurozone economies. Following the Classification of Economic Activities in the European Community (NACE), the two next charts picture these differences. The comparison is based on the measure of the value added at factor cost (i.e. gross income from operating activities after adjusting for operating subsidies and indirect taxes) and the number of employees for each sector of the economy. Graph 20 reveals important differences across member states, featuring a group with large manufacturing sectors, including Germany, Ireland, Slovenia and Finland, with more than 40% of their total added value coming from this sector. The latter also employs a large part of the working population in those countries (Graph 21).

Commentary — **Edmond Alphandéry**, Chairman of the Board of Directors, Caisse Nationale de Prévoyance (CNP), and Former French Economy Minister

"This chapter outlines the weaknesses of the SGP. But it should be stressed that, had each country done its own homework for its own sake (sound fiscal policy to avoid a burdening of the public debt, wage restraint and good incentives for competitiveness), there would have been no eurozone crisis. In other words: we need the right incentive for each country to do its homework in the first place."

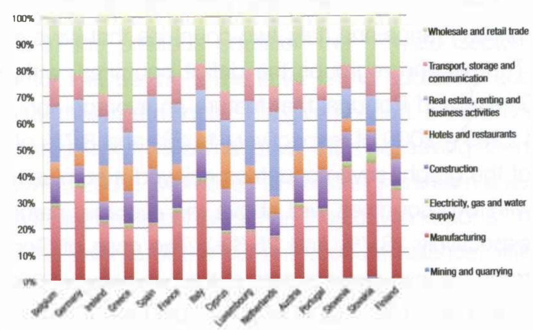
Graph 20: Value added at Factor Cost by Sector in 2006 - NACE Divisions



Source: Eurostat

The construction sector is particularly important in Spain, Cyprus, Luxembourg and Portugal. In Spain, circa 20% of the working population is employed in the construction sector, and in Cyprus it is 15%. Moreover, it is worth remarking the relative importance of the wholesale and retail trade sector in Greece in terms of valued added at factor cost and number of employees.

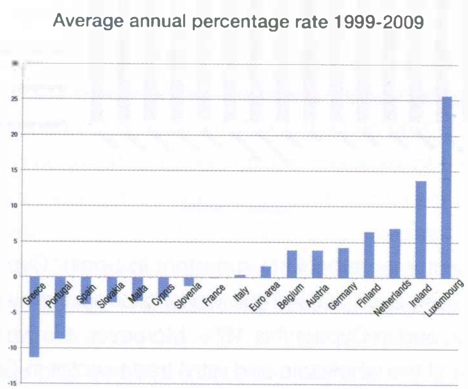
Graph 21: Employees by Sector in 2006 - NACE Divisions



Source: Eurostat

Finally, to complete the picture of real imbalances in the eurozone, we turn to the differences in trade positions among member states. Graph 22 presents the external balances of goods and services, that is to say the value of exports of goods and services less imports of goods and services, as a share of GDP.

Graph 22: External Balance of Goods and Services (% of GDP)



Source: Eurostat

The chart shows that the eurozone is split into three groups of countries. The first group comprises France and Italy, two countries that have a trade balance close to zero. The second regroups the deficit countries, with, at the far left of the graph, Greece and Portugal that feature an average annual trade deficit over the period 1999 – 2009 of respectively 11.3% and 8.7% of their GDP. On the other side of the graph, seven countries enjoyed a surplus over the period 1999 – 2009, with two countries well above the average, namely Ireland and Luxembourg (respectively 13.7% and 25.6%). The case of Germany is rather special, with a trade balance close to zero at the beginning of 2000, which then turned into a surplus of 7.1% of GDP in 2007, just before the crisis depressed the country's exports.

4.1.2 Financial Imbalances

In order to complete the previous section's analysis of eurozone imbalances, we now turn to the financial imbalances that characterise this area. We examine the balance between income and expenditure in three sectors: private, government and foreign. We describe the structure of these balances for six member states of the euro area and their evolution over the last decade, with particular attention devoted to Germany.

The British economist Wynne Godley made a substantial contribution to formalising the interconnectedness of sector financial balances. He focused his analysis on financial flows at macroeconomic level in order to give a systemic vision of financial balances. His investigation was based on the following accounting identity:

(1) Domestic Private Sector Financial Balance + Fiscal Balance + Foreign sector = 0

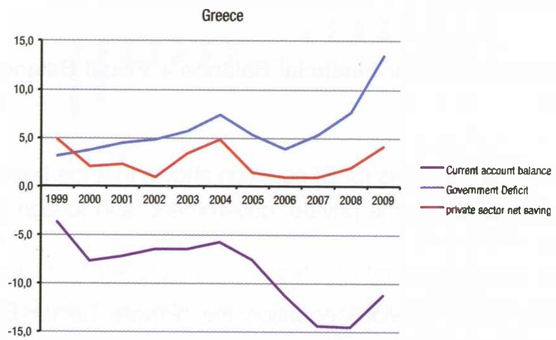
This Sector Financial Balances (SFB) equation shows that the balance between income and expenditure in the private, government, and foreign sectors must equate to zero.

We can replace in the previous equation the "Private Sector Balance" with the "Private Sector Net Saving". The latter is the addition / subtraction to net financial wealth for the private sector in a given period. If the private sector is net borrowing, then its balance will be negative; if it is net saving, then its balance will be positive (Fullwiler, 2009). Moreover, since foreigners earn a surplus by selling more exports to their trading partners than they buy in imports, the last term can be replaced by the inverse of the current account balance. The new equation we obtain is:

(2) Private Sector Net Saving + Government Deficit – Current Account Balance = 0

We apply this Sector Financial Balances approach to the eurozone's member states, and depict the evolution of private sector net savings, government deficits and current account balances from 1999 to 2009 for Greece, Spain, France, Italy, Germany, and the Netherlands. As shown in Graphs 23 and 24, the private sector balance and the government sector balance have historically moved together, with the difference between them being the current account balance (Fullwiler, 2009). Furthermore, we observe a decrease in competitiveness of some eurozone member states, as shown by the rise of the deficit of the current account balance. This decrease was sharp in Greece and Spain (Graphs 23 and 24) and smoother in France and Italy (Graphs 25 and 26). The decline started in 2001 for France and Italy and occurred later in Spain (2003) and Greece (2004).

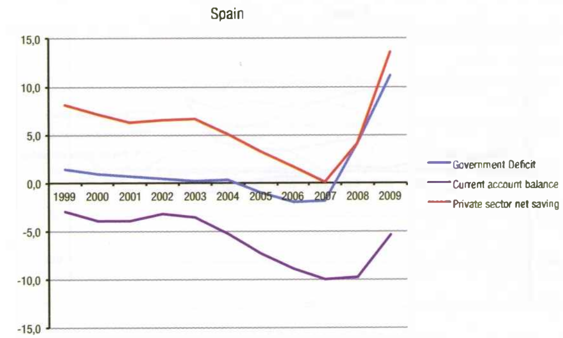
Graph 23: Greece – Sector Financial Balances (% of GDP)



Source: Eurostat, Ameco (own calculations)

"We observe a decrease in competitiveness of some eurozone member states, as shown by the rise of the deficit of the current account balance. This decrease was sharp in Greece and Spain and smoother in France and Italy"

Graph 24: Spain - Sector Financial Balances (% of GDP)

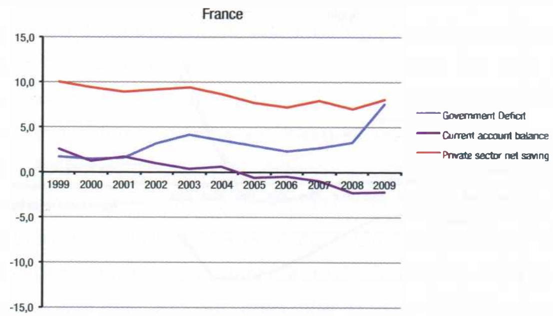


Source: Eurostat, Ameco (own calculations)

The increase of the current account deficit has been partly compensated for by the decline in private sector net saving in the four member states. This reduction in net saving has been made possible by the protracted period of financial stability and low interest rates that preceded the financial crisis, which led both non-financial institutions and, to a lesser extent, households to increase their leverage (Parenteau, 2010). Indeed, in 2007, the private sector balance was close to 0 in Greece and Spain, with respectively 0.9 and 0.1% of GDP. Normally, the private sector saves, that is, spends less than it earns, but during booms, households and businesses become profligate (Chancellor, 2010).

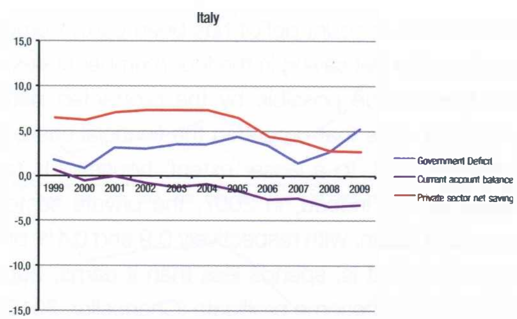
in 2007, the private sector balance was close to 0 in Greece and Spain, with respectively 0.9 and 0.1% of GDP. Normally, the private sector saves, that is, spends less than it earns, but during booms, households and businesses become profligate

Graph 25: France - Sector Financial Balances (% of GDP)



Source: Eurostat, Ameco (own calculations)

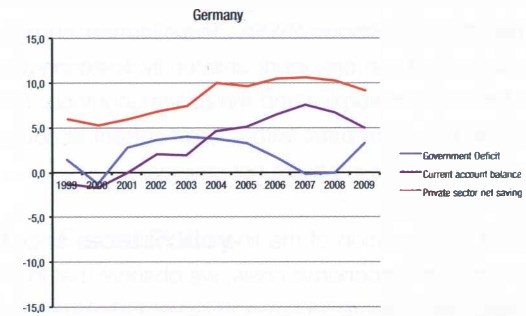
Graph 26: Italy - Sector Financial Balances (% of GDP)



Source: Eurostat, Ameco (own calculations)

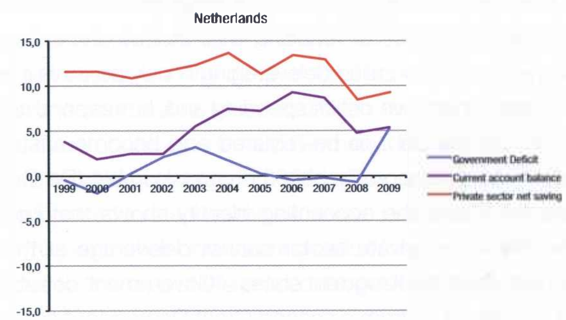
When looking at the German sector financial balances, we observe converse trends. Graph 27 shows that the German current account balance has been constantly positive and increasing from 2001 to 2007, moving from close to balance in 2001 to a surplus of 7.6% of GDP in 2007. A sustained current account surplus in a country allows either, or both, the private sector and the government to maintain a financial surplus. In fact, in Germany the private sector net saving has increased drastically from 2000 to 2007, going from 5.3% of GDP in 2001 to 10.7% in 2007. In the same way, the government deficit has decreased since 2003, achieving a slight surplus in 2007.

Graph 27: Germany - Sector Financial Balances (% of GDP)



Source: Eurostat, Ameco (own calculations)

Graph 28: Netherlands - Sector Financial Balances (% of GDP)



Source: Eurostat, Ameco (own calculations)

However, as mentioned above, for both the private and government sectors to achieve a surplus, the country needs a strongly positive current account balance. A positive current account position in one country can be achieved only if a substantial number of its main trading partners have a trade deficit (Fullwiler, 2009). Thus, the surplus of Germany has partly come as a result of the deficits of Greece, Spain, and Italy (Graphs 23, 24 and 26), and also of Portugal and Ireland (Vistesen, 2010).

Recall Graph 10 of the first section, where we saw that Germany had improved its competitiveness thanks to a decline in unit labour cost, which is similar to a competitive devaluation (Bibow, 2009). The German surplus is thus the outcome of a strategy that can only work unilaterally, fostering an evolution that is unsustainable for both the surplus and the deficit countries. The Netherlands has followed broadly the same path, with a large current account surplus, that did not reflect a genuine surge in private net savings.

If we take a look at the evolution of the financial balances since the beginning of the ongoing financial and economic crisis, we observe that in the six member states studied there was a sharp increase in government deficit. This increase came as an answer to the unsustainable debt explosion in the private sector, which had been built up over the last ten years. Consumers in a number of member states as well as financial institutions had accumulated vast amounts of private debt. With the unfolding of the crisis, consumers and financial institutions had to face a painful process of reducing their indebtedness by cutting their spending. This process of so-called deleveraging is only possible if governments are willing to increase their own deficit spending and, correspondingly, their debt levels. In fact, for private debt to be reduced and become sustainable again, government debt must temporarily become unsustainable (De Grauwe, 2009). Recall equation (1) above, the accounting identity shows that both the public sector and the domestic private sector cannot deleverage at the same time (Parenteau, 2010). Thus, as Krugman states: "Government deficits [...] are the only thing that has saved us from a second Great Depression" (Krugman, 2009).

In a nutshell, we noticed that the eurozone has built up tremendous real as well as financial imbalances over the last ten years. The evolution of these imbalances has led to a division of the eurozone between strong and weak members states. A close analysis of the "German case" has shown that the persistence of a structural external surplus participated to the development of these imbalances. The German model has been reproduced by several member states in Northern Europe reinforcing the division.

4.2 Policy Coordination

As we have seen in the first section, monetary unions rest on common pillars for monetary, fiscal and financial policies. In the eurozone, the only fully constituted pillar is the ECB (i.e. monetary policy). In the following sub-section, we analyse the implications of this lack of fully centralised fiscal and financial policies in the euro area.

4.2.1 Fiscal Policy

The fiscal policy of the EU is subject mainly to negative coordination – that is a set of rules that define what member states may *not* do – enshrined in the SGP. This instrument has given rise to waves of criticisms since its inception and suffered from weak ownership, putting in doubt the design of its rules. As early as 2002, former president of the European Commission Romano Prodi declared: "I know very well that the Stability Pact is stupid, like all rules that are rigid"[2]. At the same time, with the deepening of economic crises at the beginning of the 2000's, member states found it difficult to play by the rules set in the Pact. Indeed, three countries, namely Germany, France, and the Netherlands, breached the 3% reference value in 2003. In the autumn of the same year, the Commission proposed to step up the excessive deficit procedure of France and Germany with regard to their deteriorating deficit forecasts. However, the Council refused to move to this step of the procedure, and eventually the procedure was frozen.

Criticism arose from "small member states", which were in favour of a strict application of the rules, as well as the Commission that brought the case without real success to the European Court of Justice.

The need for a reform of the SGP was thus clear by the end of 2004 and the Commission came up with a proposal which was agreed by heads of state and government at the summit in March 2005.

2 Interview with *Le Monde* on October 18, 2002.

Three major changes should be mentioned. First, the excessive deficit procedure (EDP) would not be launched against a member state experiencing a "severe economic downturn", defined as a period of negative growth or "an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential". Second, member states recording a "temporary" deficit, or one close to the 3% threshold, will now be able to refer to a series of "relevant factors" to avoid an EDP. These factors include: negative output gap, economic cycle, implementation of structural reforms (e.g. pensions or social security reforms), investments in R&D, as well as medium-term budgetary efforts undertaken by member states to build reserves in "good times". Third, the reformed SGP extends the deadlines of the EDP. Countries will have up to two years, instead of one year in the previous pact, to correct an excessive deficit. This may be prolonged in cases of "unexpected and adverse economic events with major unfavourable budgetary effects occurring during the procedure".

"The EU still lacks instruments for systematic and effective sanctioning of excessive deficits and does not provide genuine incentives for respecting medium-term budgetary objectives, as well as coordinating national fiscal policies"

The 2005 reform has clarified the SGP's economic rationale in an attempt to increase its effectiveness and reduce the likelihood of conflict on the interpretation of the rules between member states and EU institutions. Moreover, the final text included a proposition from large member states, such as Germany and France, to introduce more flexibility in the application of the "corrective arm". However, in the light of recent developments in the eurozone, the new arrangements and procedures seem to have been ineffective in coordinating fiscal policy to the extent needed for a well-functioning monetary union. The EU still lacks instruments for systematic and effective sanctioning of excessive deficits and does not provide genuine incentives for respecting medium-term budgetary objectives, as well as coordinating national fiscal policies.

First, while the fiscal discipline of the SGP did not prove effective in the past for sanctioning deviant member states, the reformed "corrective arm"[3] seems too flexible, allowing member states to circumvent the EDP and avoid sanctions. Indeed, the extra-flexibility brought by the 2005 reform provides too many possibilities to escape the EDP, as well as too long a time frame for effectively deterring member states. Although fines formally remain part a of the enforcement mechanisms of the EDP, experience shows that they are unlikely to be imposed in practice (Buiter, 2006). Peer pressure, that is "naming and shaming", remains the only enforcement mechanism left to discipline EU members (Buiter, 2006). Yet, peer pressure does not appear to have worked as an efficient incentive for member states in the past, and there is little hope that it will do so in the future. Moreover, with the extended deadlines, the EDP can neither be implemented nor enforced in practice because countries are given such a long time to make adjustments (Euractiv, 2006).

Secondly, the set of rules within the reformed "preventive arm"[4] offer little incentive for member states to respect the medium-term budgetary objectives, a shortcoming that eventually translates into pro-cyclical bias when times are good. The commitment to achieve a medium-term budgetary position of close-to-balance or in surplus over the cycle stems from the 1997 Amsterdam European Council Resolution on SGP[5] and was designed to ensure the respect of the 3% threshold while "letting the automatic stabilisers play fully". The member states put in practice this commitment by submitting annual Stability and Convergence Programmes to the Commission. The latter assesses the programmes before the Council gives its opinion. The Council can issue, upon proposal by the Commission, "an early warning" recommendation in case there is a "significant divergence of the budgetary position from the medium-term budgetary objective".

3 Council Regulation (EC) No 1055/2005 of 27 June 2005, amending Regulation (EC) No 1466/97 on the Strengthening of the Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies.
4 Council Regulation (EC) No 1056/2005 of 27 June 2005, amending Regulation (EC) No 1467/97 on Speeding up and Clarifying the Implementation of the Excessive Deficit Procedure.
5 Council Resolution, C 236, on the Stability and Growth Pact, Amsterdam, 17 June 1997

The reformed SGP stipulates that member states should take active steps to achieve the medium-term budgetary objective, and quantifies the effort that they should make. The 2005 SGP also introduced the possibility for the Commission to issue "early policy advice".

This complex set of rules for the preventive arm has been a step forward, but did not turn out to be very successful in encouraging member states to build a budgetary position that would allow them to reach the medium-term objectives. In fact, there is evidence that fiscal policy is on average pro-cyclical under benign conditions, that is, member states tend to pursue expansionary policies when they enjoy a positive output gap, whereas they should be building up reserves anticipating future downturns. This is a serious reason for concern because this behaviour leads to insufficient deficit reduction during upswings, thus failing to create room for the full operation of automatic stabilisers in recessions (Marinheiro, 2004). Regarding possible explanations for this pro-cyclical behaviour of expenditures, we can mention: wrong estimations of the cycle, implementation lags of fiscal policy, and over-optimistic growth forecasts (Turrini, 2008). In a nutshell, the reformed preventive arm is "all stick but no carrot", that is to say, it gives the right incentives for member states to maintain their deficit under the 3% reference value in downturns, but does very little to constrain member states in the good times.

The issue of policy coordination in Economic and Monetary Union has given rise to various debates since the Delors report of 1989. The latter stated that national fiscal policies would have to abide by "binding rules" that "would permit the determination of an overall policy stance" (EC, 1989). As described above, the SGP does not seem to be an effective arrangement to coordinate budgetary policies at the EU level. In fact, the overall legislation of the EU fails to spell out clear policy principles when it comes to fiscal policy coordination. For instance, it is not clear how fiscal policy should respond to an asymmetric price shock or drop in aggregate demand. Jean Pisani-Ferry summed up this paradox explaining that the "EMU policy system is [...] long on rules and short on principles" (Pisani-Ferry, 2007). Moreover, the experience from the main instrument used for the coordination of the member states' economic policies, namely the Broad Economic Policy Guidelines (BEPGs), can hardly be considered positive (Pisani-Ferry, 2007). In fact, representatives of the member states discuss the guidelines in detail, but national policy makers frequently ignore the BEPGs. Furthermore, the eurogroup, the privileged body for policy coordination, lacks the external visibility that would ensure the recognition of its role (Pisani-Ferry, 2007).

The implication of this lack of fiscal policy coordination is that the correction of the eurozone imbalances that have been building up over the past decade, such as the German external surplus, within the current set of rules and principles will be more abrupt and painful than it would have been if the member states could endorse a more cooperative and coordinated approach (Buiter, 2006).

4.2.2 Financial Policy

With the development of the Single Market, financial markets have become increasingly integrated. In fact, 70% of EU banking assets are in the hands of 43 banking groups with substantial cross-border activities (De Larosière, 2009). As mentioned in the de Larosière report, "integration increases contagion risks, and thereby jeopardises financial stability". Yet, the Maastricht regime leaves financial regulation and supervision, to a large extent, to national authorities, which creates an asymmetry that has increased dramatically over the last decade (Lamandini, 2010). We now examine the implications of regulation and supervision of EU firms at member states' level, the consequences of this lack of cross-border financial supervision, the problem of banks "too big to save" and the absence of a mechanism to address policy failures.

European regulatory and supervisory policies rely mostly on home country control for large complex financial institutions (LCFIs). However, some safeguards have been created in EU law for host state supervisors to act in emergency situations to protect depositors. Moreover, colleges of supervisors have been established to deal with cross-border institutions. These colleges gather supervisors from both the home and host-country to discuss supervisory issues and take decisions with regard to specific LCFIs (Lawson, Barnes, & Sollie, 2009). Even though these measures have been a step forward to improve financial supervision, host member states still largely depend on the effectiveness of supervision carried out in the home member states (Lamandini, 2010).

With regard to financial regulation, member states are given a wide range of options to enforce EU directives, which eventually translates into important diversities across national transpositions. For instance, the definition of regulatory capital for financial institutions, or the methodology to validate risks assessments, differ extensively from one member state to another (De Larosière, 2009). These differences may be explained by the negative correlation between regulation and profitability, so countries reduce their level of regulation to attract very mobile capital (Lamandini, 2010).

Turning to financial supervision, Committees have been created to facilitate cooperation and exchanges of information within the financial sector. We can distinguish four main Committees. First, the European Banking Committee (EBC) supports the European Commission in preparing new banking community legislation. Second, the Committee of European Banking Supervisors (CEBS) has been entrusted with the task of promoting cooperation among supervisors, as well as favouring the convergence of supervisory practices. It also plays an active role in the application of EU regulations. Third, the EU *Groupe de Contact* (GdC) gathers national supervisors of banks to exchange information. The last Committee is the Banking Supervisory Committee (BSC), under the responsibility of the ECB, providing a forum for regular collaboration between central banks and supervisory authorities.

This complex macro-prudential supervision, encompassing committees and colleges of supervisors, has not proved efficient in anticipating the crisis and managing the consequences for the financial sector. The lack of effective coordination within the colleges of supervisors played a major role in preventing them from promptly detecting and properly reacting to the market failures leading to the crisis (Lamandini, 2010). Moreover, the committees excessively focused their investigations on individual financial institutions, which has turned out to be an inadequate tool for analysing systemic risks (Lamandini, 2010).

In addition, the financial turmoil has shown that home country control was an out-dated tool for dealing with large and complex financial institutions. A major drawback of the home country approach is that for some member states it may be difficult to bear the cost of the bail-out of a large financial institution. In fact, some banks turn out to be "too big to fail" with regard to their level of equity, which represents a substantial share of the GDP of some member states, such as Ireland, Belgium, or the Netherlands (Dermine, 2005). A related issue is that some banks have become "too complex to fail". Indeed, for some financial institutions with significant cross-border activities and non-bank activities (e.g. insurance or asset management), it would be very difficult to put them into receivership if they ran into financial distress (Dermine, 2005). Furthermore, some LCFIs are so vast and complex that it is difficult to assess the risks to which they are exposed or the risks that they represent for the financial system as a whole. Given their size and the structural function they have for the financial system as a whole, they also turn out to be "too big to manage", that is to say that they can expose the rest of society to major costs and are subject to acute moral hazard (De Larosière, 2009).

Commentary — **Daniel Daianu**, former Romanian Finance Minister and former Member of the European Parliament

"The reform of regulation and supervision has to target structure. The Volcker Rule, as advocated by Lord Turner and Vince Cable in the UK, and some EU reforms point in the right direction. But more is needed - not least to prevent regulatory arbitrage. Regulations need to be comprehensive, which means that the shadow banking sector (hedge funds, private equity funds, special purpose vehicles) should be covered with no exception. Monetary policy would be re-defined; price stability plus financial stability would make simple rules a thing of the past. In the EU regulation and supervision have to acquire a clear European dimension and impact."

The existence of banks "too big to fail" or "too complex to fail" is a particular issue in the EU since there is no central supervisory authority for the financial system that would be responsible for guaranteeing financial institutions in distress.

As seen above, member states are in charge of bailing out their banks. Yet, markets have expressed doubts concerning the ability of some weaker member states to deal with large and complex financial institutions. These doubts have been reflected on the market for government bonds with some member states paying a high-risk premium to be able to trade. This tendency has been aggravated by the implementation of sizeable fiscal stimulus measures to support financial institutions, which saw an increasing number of countries refinancing their financial markets.

Among the countries most severely hit, Greece suffered from a sharp increase in its government bonds spread compared to Germany (recall Graph 14 in section 2). The crisis has highlighted the fact that the euro is a monetary union but not a political union. Even though the ECB has fulfilled its role to provide liquidities to sustain credit activities on the financial market, only a Treasury could address the problem of solvency that characterises the economies of some weaker member states.

In conclusion, we observed that the eurozone has built up huge imbalances over the last decade. Member states in Northern Europe have enjoyed tremendous current account surpluses, while Southern countries, such as Greece, Italy, Spain and Portugal suffered from an increasing lack of competitiveness. The financial crisis has highlighted these imbalances and further amplified their consequences. The euro area lacks effective fiscal and financial instruments to deal with imbalances and manage the consequences of financial turmoil. Fiscal policy in the EU is subject mainly to negative coordination, which did not prove successful organising the fiscal response of member states. Financial supervision failed to detect and properly manage the consequences of the crisis. The lack of arrangements within the eurozone to support weaker member states translated into doubts on the part of financial markets, which further destabilised the area.

5 Enhanced Fiscal and Financial Integration

The eurozone is "levitating", Charles Wyplosz said, maintained in mid air by the hope that reform proposals will be implemented in the very near future and address effectively the underlying causes of the crisis (Wyplosz, 2010). The market run on public debts was eventually stopped in early May, when the ECB decided to buy government bonds from weaker member states. This extraordinary move has given the EU some, but not unlimited, time "to build out the institutions of its monetary union" (Barry Eichengreen, 2010).

First steps toward closer economic governance were taken in March, when European leaders agreed to launch a task force to reform both the EU and the eurozone. The task force is chaired by Herman Van Rompuy, EU Council President, and made up of the finance ministers from the 27 EU member states.

The European Commission has also proposed several measures to be implemented as early as next year. Commission President, José Manuel Barroso, during a speech in early May, declared that a monetary union cannot work without an economic union, and he warned that member states "should have the courage to say whether they want an economic union or not [...], if they don't, it's better to forget monetary union all together" (Euroactiv, 12/05/2010).

The present section will introduce lines of policy action for revising the regulatory and supervisory frameworks of the EU and the eurozone, beyond what has been proposed by the Commission and the task force. Our proposals aim at transforming the eurozone into a fully-fledged economic and political union, a necessary step if we want the common currency to survive in the long run.

A pragmatic reform agenda should provide the EU and the eurozone with better fiscal discipline, more effective financial supervision, a crisis resolution mechanism, and an exit strategy from the crisis to promote growth and competiveness.

5.1 Fiscal Discipline and Cohesion

Paul De Grauwe recently explained that the way out of the crisis for the eurozone depends on its "capacity to move forward into a political union" (De Grauwe, 2010b). If full integration does not seem likely, he made clear that some "minimum ingredients" are necessary to keep the eurozone alive in the long run. The eurozone and the EU need fiscal reforms that should include improving budget policy coordination, introducing tighter fiscal rules with tougher sanctions for countries breaching the SGP, and placing more emphasis on debt levels and evolutions.

At the eurozone level, the eurogroup's authority should be reinforced by making use of article 136 of the Lisbon treaty, which allows members of the Council whose currency is the euro to take specific measures in order "to strengthen the coordination and surveillance of their budgetary discipline"[6].

At the EU level, the Commission has put forward proposals to strengthen the SGP in the form of two Communications released during the first semester of 2010. The May[7] and June[8] Communications include propositions to increase fiscal policy coordination and ensure better functioning of the SGP. During a European summit in Brussels in June 2010, EU leaders broadly endorsed the Commission's proposals on economic governance, with the United Kingdom securing an opt-out[9].

The Commission has proposed the establishment of a "European semester" of budgetary surveillance. Under this proposal, EU countries will be asked to submit their draft annual budgets in April of each year to the Commission. The latter will analyse the assumptions on which budgets are based (e.g. economic growth, inflation, and interest rates forecasts) and in some cases propose "country-specific policy guidance" in early July.

6 Art. 136, paragraph 1, Treaty on the Functioning of the European Union
7 Com. (2010) 250 final, *Reinforcing Economic Policy Coordination*, Brussels 12/5/2010
8 Com. (2010) 367/2, *Enhancing Economic Policy Coordination for Stability, Growth and Jobs – Tools for stronger EU Economic Governance*, Brussels
9 EUCO 13/10, Conclusions, Brussels, 17/06/2010

In the second half of the year, member states will review each other's annual budgets in a kind of peer review system. Afterwards national parliaments will vote on the budget.

The "European semester" initiative will apply to all member states, but the monitoring of national budgets will be tighter for those that have adopted the euro. In fact, the peer review conducted in the eurogroup should act as an early warning for eurozone members found to breach the SGP limits.

Commentary — **Edmond Alphandéry**, Chairman of the Board of Directors, Caisse Nationale de Prévoyance (CNP), and Former French Economy Minister

"This chapter describes the various eurozone governance issues. One important point should be emphasised: with more regulation (Basel III, Solvency II), we have to be careful not to create a risk adverse bias in Europe. This would be an obstacle to economic growth and employment."

According to the European Commission, a prerequisite for an effective functioning of the "European semester" is "to strengthen Eurostat's mandate to audit national statistics" (EC, 2010a). Steps in this direction were taken in June 2010, when ministers gathered in Luxembourg and approved an overhaul which gave new powers of enquiry to Eurostat. In its new role, the EU statistics agency will be able to check whether countries are respecting the SGP or not, and will have the power to demand more information on member states' accounts, including sending missions to those suspected of submitting false budget reports.

In its attempt to further improve fiscal coordination, the Commission has also called for national laws reflecting the treaty's objectives on budget deficit and debt consolidation. Member states have been encouraged to follow the German example, the country anchoring into its Constitution a "debt brake" setting a limit on non-cyclical structural borrowing of 0.35% of GDP from 2016.

Jean Pisani-Ferry supports the idea of "domestic institutional reforms", and says the EU fiscal framework should tend towards a more decentralised system. Markets should assess a countries fiscal creditworthiness using Germany and its new budget rule as benchmark, he says, adding that Germany "might become the fiscal policy anchor as it became the monetary policy anchor in the European Monetary System" (Pisani-Ferry, 2010b).

To give teeth to fiscal surveillance, the Commission has also proposed sanctions under the preventive arm. These sanctions would concern exclusively eurozone countries that make insufficient progress towards their medium-term budgetary objectives during good economic times. The sanctions would take the form of an interest-bearing deposit that could be released when the member state concerned makes sufficient efforts to address the issues. On the contrary, countries that have accumulated large surpluses during good economic times would be allowed to spend more during downturns without fearing EDP.

Tougher sanctions would apply for countries that are found to have broken the deficit and debt limits. The sanctions would include cuts in expenditures related to cohesion policy, Common Agricultural Policy and the fisheries fund. The question of sanctions remains nevertheless problematic because, as indicated by Peter Bofinger and Stefan Ried, "the punishment of a country in trouble even increases the trouble instead of putting (the country) back on track" (Bofinger & Ried, 2010).

During the June 2010 Summit, European leaders also agreed that further emphasis should be placed on "levels and evolutions of debt and overall sustainability". Sanctions would not be based on absolute figures (to avoid immediate action), but would be imposed on countries that did not show a positive evolution as regards their debt trends. The most controversial issue is how to measure debt. Some countries, such as Italy, would prefer to measure "aggregate debt" including private alongside public debt (Euroactiv, 18/06/2010). Paul De Grauwe also suggested that the SGP should include private and public debt developments (De Grauwe, 2010b).

Among the countries that actively contributed to shaping the future of EU economic governance, France and Germany play a crucial role. The former defended closer fiscal integration and coordination, with reforms based on the existing treaties in order to speed up the process. The latter advocated stricter rules to reinforce the SGP, such as the ability to temporarily withdraw voting rights in the EU Council of Ministers, or to expel a eurozone member that repeatedly broke the SGP. These radical measures suppose changing the existing treaties.

"The EU should implement tighter fiscal rules with tougher sanctions under the preventive and corrective arms of the SGP, and put more emphasis on overall sustainability"

The two sides eventually formed a common proposal in July on EU economic governance. Both countries agreed that no formal institution should be responsible for the economic governance of the eurozone, but that regular EU summits should play that role. In a concession to Germany, France accepted that governments who breach the SGP limits could have their voting rights suspended. The joint statement also argues in favour of "leveraging all options offered under the existing treaties" in order to "move swiftly and operationally" on reforming the governance of the eurozone (Merkel & Sarkozy, 2010).

The ECB rejected a proposal from Germany to expel a member state from the eurozone as a last resort, saying it could undermine the stability of the monetary union (Athanassiou, 2009). However, the ECB is in favour of changing the Lisbon treaty to enhance the power of the European Commission. In its proposal to reinforce economic governance in the euro area[10], the ECB defends the idea of "initiating the EDP procedure quasi-automatically". It also claims that the burden of proof should be shifted to the country that is in breach of the rules, under which it would have to prove that it does not deserve to be punished.

10 ECB, ***Reinforcing Economic Governance in the Euro Area***, 10/05/2010

The European Parliament also reacted to the proposals made by Paris and Berlin. The heads of the four main political groups denounced the shift towards inter-governmentalism at a time when a Community approach is called for. MEPs called on EU leaders to abandon the open method of coordination, which uses peer pressure to ensure governments meet their targets, "in favour of stronger instruments".

In a joint proposal they argued for more powers to be given to the European Commission that should, according to Guy Verhofstadt, "be in the driver's seat for economic governance" (Euroactiv, 15/06/2010).

Some scholars have expressed doubts about the feasibility and necessity of EU economic governance. Charles Wyplosz said that only national institutions could guarantee fiscal discipline. According to him, the SGP should be decentralised and "independent national fiscal boards" created to ensure fiscal discipline (Wyplosz, 2010).

Reinforcing fiscal discipline at the eurozone level is of crucial importance in order to improve economic governance. The Commission's proposal to create a European semester goes in the right direction, attempting to improve budget policy coordination. In addition, the EU should implement tighter fiscal rules with tougher sanctions under the preventive and corrective arms of the SGP, and put more emphasis on overall sustainability. These measures would provide the right incentives for member states to respect deficit and debt limits anchored in the treaties.

The debate between European leaders, MEPs, ECB executives and scholars, has highlighted two essential questions regarding the role of the European Commission towards reformed economic governance and the necessity to change the existing treaties.

First, fiscal reform should delimit the responsibility of each body within the EU decision-making framework, and make clear how much power should be given to the European Commission. Eurozone leaders would like fiscal policy to remain at the eurogroup level. But the open method of coordination has proved to be an inefficient instrument. The Commission should play a more prominent role.

Second, the real question concerns the extent to which the new powers are consistent with existing Treaties. The ECB has expressed its support for a change of the legislation in order to increase the European Commission's power, while a number of member states are unwilling to engage in such a long process, recalling the painful ratification of the Lisbon treaty. It is doubtful, however, whether existing treaty arrangements are sufficient for effectively enhancing the Commission's fiscal authority.

5.2 Treasury and Financial Supervision

In July 2010, EU regulators released stress-testing results for 91 European banks. The exercise revealed how banks would end up if the economic situation were to worsen and financial market conditions deteriorate. Only seven banks failed the stress test, including five so-called Spanish Cajas, as well as German Hypo Real Estate and Greek lender ATEbank (CEBS, 2010). The stress test, made available to the public, has clearly improved transparency, and "eased the concerns of investors around the European banking system" (Shah, 2010).

Despite these positive results, European financial markets remain one of the biggest threats to eurozone survival in the long run. As expressed by the IMF, "the experience of the crisis showed that a comprehensive financial stability framework was lacking and that much work is needed to fill this gap" (Beattie, 20/07/2010). The EU needs to rethink and rebuild its financial system, which has proved to be inefficient in anticipating and managing the crisis. Consolidation should occur primarily at the EU and eurozone level, because "fragmented financial regulation and supervision makes no sense in a monetary union and is potentially lethal" (Münchau, 2010).

Proposals should include improving regulation and supervision at the EU level, and providing a financial resolution mechanism for banks that are in trouble.

First of all, the EU needs a common rulebook for financial regulation that would address the problems posed by naked short selling and Credit Default Swaps. Regulation should also tackle capital and liquidity requirements for banks in order to provide a strong buffer against failure.

In a joint letter to the president of the European Commission, French president, Nicolas Sarkozy, and German chancellor, Angela Merkel, advocated better regulation on financial trading (Merkel & Sarkozy, 2010). They asked for a common framework to deal with sovereign Credit Default Swaps, a form of insurance against government debt default, and naked short selling, which corresponds to the practice of selling a financial instrument without borrowing it first. Germany had attracted criticism from other member states after taking the unilateral decision to curb naked short selling. Members of the European Parliament have proposed that a newly created pan-European authority should be responsible for banning potentially toxic financial products (Tait, 13/07/2010).

Regarding financial supervision, proposals from the high-level group chaired by Jacques de Larosière have paved the way for better cooperation and coordination at the EU level. In March 2009, the European Commission endorsed the de Larosière recommendations and released a Communication[11] laying the foundations for a "new supervisory framework". The reform drawn up by Charlie McCreevy, former commissioner for the Internal Market, establishes four new bodies in charge of financial supervision. A European Systemic Risk Board (ESRB) that will protect the stability of the financial system and be responsible for macro-prudential oversight and three authorities in charge of micro-prudential supervision: a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA) and a European Securities and Markets Authority (ESMA).

Some member states, spearheaded by the United Kingdom, sought to impose restrictions on the power of the new supervisors, while MEPs argued in favour of extensive powers. EU negotiators eventually reached an agreement in early September 2010, deciding that the new supranational institutions could overrule national authorities only in some predefined scenarios, in particular when national supervisors are in breach of EU law, and when an emergency has been called by member states (EP, 2010).

11 Com. (2009) 252 final, Brussels 27/5/2009

Finance ministers adopted the final package of measures on September 7, while MEPs gave the green light on September 29. Thus, the four new supervisory authorities started operating in January 2011.

Jose Manuel Garcia-Margallo, a Spanish MEP, welcomed this "ambitious legislation" that should help to protect European citizens, and added that it constitutes "a big step for European economic integration" (Tait, 22/09/2010). But influential EU voices have criticised the final text for ignoring important aspects of the de Larosière report. According to Wolfgang Münchau (2010) "what started off as a deeply unimpressive set of recommendations [...] ended up further diluted as it proceeded through the EU's legislative mills". At the centre of the controversy are the powers attributed to the new authority responsible for macro-prudential surveillance. As outlined by Richard Portes, "there are no binding powers for the ESRC" (*Friends of Europe*, 2009).

French Socialist MEP, Pervenche Berès, claimed that more power should be granted to the new ESMA, including the provision of enhanced protection for consumers. She proposed that ESMA be given the task of "registering financial innovation products as prototypes", authorising their selling on the market, monitoring them and banning them if necessary. Beyond the protection of consumers, she said this should ensure that "financial markets are geared towards long-term investment" (Berès, 2010).

The final package adopted by the Council and the Parliament includes an obligation for the Commission to make recommendations every three years on whether the European Supervisory Authorities should be entrusted with additional powers (EP, 2010), underlying a recognition that the powers presently accorded to them might prove to be inadequate for ensuring an effective functioning of financial supervision.

As part of the institutional framework created by the Commission, some have advocated the establishment of a European public rating agency, to compete with the so-called "big-three" American credit rating agencies that have played a crucial role in the boom of the sub-prime market by failing to assess the risk of those securities. Criticisms have been raised concerning the neutrality of their evaluation, which has cost the agencies a good part of their credibility. Dorothea Schäfer has proposed to set up a public agency whose rating should be mandatory. She said that the initiative should include at least the eurozone members (Schäfer, 2010).

To complement the reforms proposed by the de Larosière Committee, the EU needs to create a genuine bank resolution mechanism that would deal with cross-border bank failures. The mechanism would be part of a wider EU crisis management framework and combine a bank resolution Authority and a financial stability fund. The goal of such a system would be to alleviate member states' taxpayers from the burden of bailing out banks that are in trouble.

H. Ruding (2010) has drawn up plans for a European crisis resolution mechanism. This would presuppose the creation of a resolution Authority "whose goal should be to avoid the serious disorder in the financial markets when a bank of large (or even moderate) size collapses". Ruding's proposal involves extensive powers for the newly created Authority, such as the capacity to seize a bank before it goes bankrupt and take control of certain assets it possesses. It could also remove its management, and freeze the rights of shareholders. Such a resolution Authority would address the problem posed by "too big to fail" banks because the Authority could decide and manage an orderly default. Moreover, this system would reduce moral hazard, because it will become much less likely that governments will intervene in a systemic bank failure through a "traditional" bank bail-out with a heavy contribution from the taxpayers. Under the proposal of Ruding, the resolution Authority would be coupled with a "special fund for burden-sharing of rescue operations". Its goal would be to make funds available for the financing of any future official support for cross-border banks.

Charles Goodhart explained that the main constraint would be the financing of such a resolution mechanism, because "governments are not going to hand over financial crisis prevention mechanisms if they have to pay the bill for crisis resolution. If we want crisis prevention, supervision and regulation taken to a supranational level, then we will have to support that with sufficient supranational source of funding to deal with cross-border crises" (*Friends of Europe,* 2009).

Dominique Strauss-Kahn made the case for a European Resolution Authority (ERA). According to him, the system should be financed by the banking industry through deposit insurance fees and bank levies (Ruding, 2010). Michel Barnier also spoke in favour of a "European emergency fund" and proposed that it be financed either by bank taxes or annual insurance premiums.

The European Commission in a recent Communication[12] also supported the creation of a bank resolution fund that would apply the so-called "polluter pays" principle to the financial sector. However, the Commission warned that the resolution fund "must not be used as an insurance against failure or to bail-out failing banks, but rather to facilitate an orderly failure". In its view, the fund should be built up on the basis of contributions from banks ex ante.

Finally, the EU should implement the recent decisions of the Basel Committee on Banking Supervision concerning the increase in capital and liquidity requirements for financial institutions so as to reinforce the resilience of the eurozone's banks to shocks.

On September 12, 2010, banking regulators agreed to triple the size of banks' capital reserves. The Basel III package increases the minimum common equity requirement from 2% to 4.5%, and sets a new capital conservation buffer of 2.5%, which brings the total common equity requirements to 7% (BIS, 2010).

Jean-Claude Trichet explained that the new arrangements are "a fundamental strengthening of global capital standards", which should contribute to "long term financial stability and growth" (BIS, 2010).

Others have expressed the view that they might create an adverse risk bias in Europe. The reform package has also been criticised for its extended implementation period. Indeed, the new rules on capital requirements will be phased in between January 2013 and January 2019. But Michel Barnier argued that the transition period is "right" because if deadlines were too short they would slow down economic recovery (Masters, 2010).

12 Com. (2010) 254 final, Brussels 26/5/2010

5.3 Bail-out Mechanisms and Crisis Resolution

In May 2010, eurozone leaders embraced two bold moves in order to save the euro, which threatened to collapse under the weight of debt accumulated in some member states. EU finance ministers agreed a Greek bail-out worth €110bn., and took the decision to establish a European Financial Stability Facility. The latter is a special purpose vehicle that will be able to issue bonds guaranteed by euro area members. The money raised will serve to make loans to member states in distress up to a maximum amount of €440bn. The EFSF may be combined with loans from the IMF up to €250bn., and from the new European Financial Stabilisation Mechanism, created by the Commission, up to €60bn. Although only three of the EFSF's shareholders hold triple A ratings, namely Germany, France and the Netherlands, the new fund is expected to receive a similar rating said Klaus Regling, EFSF's new Chief Executive (Peel & Wilson, 2010).

Paul De Grauwe recognised that the creation of the EFSF goes in the right direction, that is, the creation of a "fire brigade" acting as lender of last resort for member states unable to refinance in the financial markets (De Grauwe, 2010b). However, he pointed out that the new facility "falls short of an automatic insurance mechanism", because it involves a network of bilateral loans from which individual countries could easily pull out (De Grauwe, 2010b). But the crisis has shown that monetary union forces its members to provide assistance to their weaker partners, whether they want to or not. This is the reason why the eurozone, in order to survive, needs an "explicit solidarity mechanism", whether it involves a common Eurobond, a European Monetary Fund or fiscal transfers between member states.

Paul De Grauwe and Wim Moesen put forward the idea of a Eurobond in a recent article titled "Gains for All: A Proposal for a Common Eurobond". Under their proposal, each member state would participate in accordance to the capital share it holds in the ECB. The interest rate each participating country should pay under this mechanism would depend on the interest rate it pays in its own market, so that more disciplined governments would pay lower interest

rates. The Eurobond interest rate would then be the "weighted average of these national interest rates" (De Grauwe & Moesen, 2009).

Dominique Strauss-Kahn has expressed support for a common Eurobond that would allow member states to "borrow on the basis of common liability rather than national liability" (Giles, 2010). Members of the four main political groups in the European Parliament also welcomed the idea. But some have criticised the Eurobond instrument for lacking effective conditionality that would trigger fiscal consolidation in weaker member states (Bofinger & Ried, 2010). Although weaker countries, on account of their fiscal position, would pay higher interest rates, they would not be forced to take further actions to improve that position.

Alternatively, explicit solidarity could be provided through a European Monetary Fund (EMF), as suggested by Daniel Gros and Thomas Mayer (Gros & Mayer, 2010). Such a fund would manage and finance assistance programmes for weaker eurozone members along the lines of the IMF. If the financial situation of the country were to worsen despite the help provided by the EMF, the latter could administer a debt restructuring, and split the resulting losses between private creditors and governments backing the fund. The implementation of the EMF would not require treaty change according to the authors, but could be done using the enhanced cooperation clause. Moreover, the stabilisation programme for Greece, as well as the European Financial Stability Facility, could be merged into the fund to ensure rapid functioning (Mayer, 2010). ALDE group in the European Parliament said that EMF would provide "the solidarity but also the discipline where the old Stability and Growth pact was lacking" (Euroactiv, 15/05/2010).

Angela Merkel has expressed support for a European Monetary Fund. She has the backing of her minister of finance, Wolfgang Schäuble, who recommended that "strict conditions and a prohibitive price tag must be attached so that aid is only drawn in the case of emergencies" (Schäuble, 2010). He also suggested that aid provided by the EMF be coupled with stricter sanctions under the EDP, such as non-refundable monetary penalties. Moreover, he designated the eurogroup as the forum where political decisions concerning the aid should be taken in agreement with the ECB.

But some questions remain over the implementation of such a fund. Gros and Mayer have proposed that the EMF be financed by member states breaching the SGP, in proportion to how much they exceed the limits by. Under their proposal, weaker member states would be forced to pay into the fund, whereas they could use the money to consolidate their fiscal position. According to Luke Baker, the proposal would be "an insurance premium paid into a rainy-day fund for the EU's most financially profligate", a "bitter medicine" that would not create explicit solidarity (Baker, 2010). Furthermore, Ulrich Häde pointed out that this method of financing could enter in to conflict with the treaty dispositions for EDP, because the latter clearly states the conditions under which penalties should be decided (Häde, 2010).

"In the longer run, the eurozone's sustainability will depend on its capacity to turn the facility into a properly funded agency capable of providing financial assistance, issuing Eurobonds and managing default procedures in a credible way"

Dominique Strauss-Kahn suggested another way to address solvency problems in the eurozone. He proposed the introduction of short-term fiscal transfers between euro area members. The IMF Managing Director advocated "stronger surveillance and tools to organise transfers from one part of the area to other parts" (Giles, Barber, & Oakley, 2010). These should be short-term rather than permanent transfers to avoid resistance from countries like Germany or the United Kingdom.

The creation of the European Financial Stability Facility, headquartered in Luxembourg, has given the right signal to markets, clearly stating that no member states will be left behind. Eurozone members did not become suddenly open-handed, but monetary union forced them to show solidarity. However, the EFSF is an *ad hoc* temporary mechanism, not a solid institution. In the longer run, the eurozone's sustainability will depend on its capacity to turn the facility into a properly funded agency capable of providing financial assistance, issuing Eurobonds and managing default procedures in a credible way.

An explicit solidarity mechanism would require a secure source of financing. Under the proposal made by Gros and Mayer, the financing of the EMF would rely on contributions from more profligate member states, adding a supplementary burden on countries that are in trouble. European leaders should look for a source of financing that could guarantee its effective functioning and at the same time create a real automatic solidarity mechanism. At the December 2010 Summit they agreed to proceed to a revision of the treaty that would open the way to set up a European Stability Mechanism for financing rescue programmes while allowing for orderly default procedures that involve the private sector.

5.4 Towards a Growth Strategy

European economic cooperation should continue beyond the immediate management of the crisis in order to define a clear exit strategy and put the EU back on track. Ian Begg declared that "the redefinition of European capitalism [...] and of what the European social model can offer" was at stake (Begg, 2010b). The Commission came out with a growth agenda titled "Europe 2020"[13], which received the go-ahead from the spring 2010 European Council. The project addresses the underlying causes of the crisis and sets out common economic policy for the future of the eurozone and the EU. The 10-year plan includes initiatives for raising employment participation rates, boosting investment in research, cutting greenhouse gas emissions, improving education levels and lifting millions of people out of poverty.

José Manuel Barroso said that the new "strategy for smart, sustainable and inclusive growth" should bring "at least 2% growth" to the EU (Euroactiv, 03/03/2010). The strategy comprises five headline targets that should help the EU to achieve this objective. The five targets include:

- Raising the employment rate of the population aged 20-64 to 75%.
- Raising the investment in R&D to 3% of the EU's GDP.

13 Com. (2010) 2020, ***Europe 2020 A Strategy for Smart, Sustainable and Inclusive Growth***, Brussels, 03/03/2010

- Meeting the EU 20/20/20 objectives on greenhouse gas emission reduction and renewable energies.
- Reducing the share of early school leavers to under 10% and making sure that at least 40% of the younger generation has a tertiary degree.
- Lifting 20 million people out of poverty.

Some of the targets are not new and recall objectives set by the Lisbon agenda, such as the spending on R&D, which only Sweden and Finland achieved under the previous strategy (Rondel & Corbis, 2010).

To complement these five headline targets, the Commission proposed seven "flagship initiatives" that should make up the future EU agenda and be translated into concrete actions with regard to innovation, education, digital society, climate and energy, mobility and competitiveness, skills and jobs and fighting poverty. The EU objectives will be further translated into national goals, ensuring that member states adapt the Europe 2020 strategy to their particular situation.

Commentary — **Daniel Daianu**, former Romanian Finance Minister and former Member of the European Parliament

"National policies can make a difference. This is a lesson of the past decade regarding the Lisbon Agenda. The strong performance of Scandinavian countries shows that unless EU-wide guidelines and policies are buttressed by national reforms, the outcomes are quite disappointing. But the current crisis demands a much better defined and more effective framework for EU policy coordination. Tackling EU imbalances demands that adjustment burdens be shared among surplus and deficit economies. An EU-wide industrial policy would also make sense."

The new growth agenda addresses some of the weaknesses of its predecessor, notably by including tighter monitoring of national reform programmes. The Commission proposed that member states elaborate simultaneously their Europe 2020 reports and their stability and growth programmes, although the SGP and the Europe 2020 strategy remain distinct instruments. Afterwards, the Commission will submit an annual report to EU leaders, who will discuss it during the spring Council. The Commission will also be able to address country-specific recommendations to member states, and in case of an inadequate response issue policy warnings[14].

Some have criticised the Europe 2020 headline targets for lacking a clear economic rationale. László Csaba claimed that the quantitative objectives "look quite arbitrary, following political convenience rather than any academic standard" (Csaba, 2010). Moreover, the Commission should have put more emphasis on the specific policies that would help to achieve the targets. Another crucial issue missing from the headline targets, according to Fabian Zuleeg, is "the sustainability of public finances". In fact, the EU's challenges concerning ageing populations and public sector structural reforms should have had a more prominent role in the Europe 2020 strategy (Zuleeg, 2010).

Beyond these critiques, the biggest challenge faced by the EU is how to effectively implement these initiatives and avoid a repetition of the Lisbon Agenda process, which has failed to turn the EU into "the world's most dynamic knowledge-based economy". For the Europe 2020 strategy to work, the EU needs to improve economic governance in order to address macro-economic imbalances, to draw up a substantial budget to deal with the seven flagship initiatives, and to deepen its Internal Market.

The crisis has highlighted that internal imbalances threaten the long-term survival of the euro and the stability of the EU as a whole. A growth agenda should include initiatives to identify and monitor these imbalances.

14 Art. 121, paragraph 4, of the Treaty of the Functioning of the EU

According to Paul De Grauwe, such a scheme would have to ensure that "both deficit and surplus countries change their policies", because he said, "there are not good imbalances and bad imbalances – just imbalances" (De Grauwe, 2010b). On the one hand, countries with large current account deficits, such as Greece or Spain, would need to reform their labour markets for real wages to adjust. On the other hand, Germany or the Netherlands should implement policies to stimulate consumption (Münchau, 2010).

Europe 2020 provides a strong basis for addressing macroeconomic imbalances. However, the strategy continues to display weak governance and inadequate enforcement mechanisms. Ministers of finance should play a prominent role both at national and European level. They are the real coordinators of the strategy, given that the national reports are to be included in the framework of the stability and growth programmes (Pochet, 2010). But, the open method of coordination has attracted many criticisms, because, as mentioned by the ALDE group in the Parliament, "member states will always lack the political will for self criticism" (Euroactiv, 03/03/10). So Europe 2020 needs a more effective system of incentives, with "carrots and sticks" to ensure that member states meet the targets.

"For the Europe 2020 strategy to work, the EU needs to improve economic governance in order to address macro-economic imbalances, to draw up a substantial budget to deal with the seven flagship initiatives, and to deepen its Internal Market"

Herman Van Rompuy has called for new incentives under the Europe 2020 strategy[15]. He proposed to reward member states with extra EU funding if they adopt reforms that contribute to achieving the Europe 2020 objectives. The funding could come from the European Investment Bank or the EU's regional and research budgets.

15 Herman Van Rompuy, ***Seven Steps to Deliver on the European Strategy for Growth and Jobs***, Brussels, 08/02/2010

At the eurozone level, the peer review currently conducted in the eurogroup should be upgraded into a structured surveillance framework, including as suggested by the ECB, a "traffic light" system for countries losing competitiveness (ECB, 2010b).

This framework would imply deeper surveillance and stronger policy coordination than envisaged under Europe 2020. Wolfgang Münchau said "Jean-Claude Juncker, the Prime Minister of Luxembourg and chairman of the eurogroup, should make imbalances the defining issue of his agenda and propose binding policies" (Münchau, 2010).

Furthermore, in order to reach these ambitious targets, the EU would need a substantial budget. But the crisis has left member states with little room for manoeuvre and an increase in their direct contribution to the EU budget would be unthinkable. Janusz Lewandowski, the Commissioner responsible for Budget and Financial programming, has said: "I'm hearing from a number of capitals, including important ones like Berlin, that they would like to lower their contributions to the European Union. Many countries want to be unburdened. In this way the door has been opened to think about revenues that are not claimed by finance ministers" (Martin, 2010). He suggested that a financial transaction tax, or aviation taxes could provide the EU with sufficient additional sources of revenue. Laurent Fabius also expressed his support for taxes levied at the EU level that would substitute for national taxes. He said a considerable budget would avoid repeating the failure of the Lisbon strategy and allow the EU to implement ambitious initiatives (Fabius, 2010).

Finally, the EU growth agenda should include reform of the single market, following the recommendations of Mario Monti[16]. In his "package deal", the former commissioner for the Internal Market proposes to build a "stronger single market" based on support for a more resource efficient and low-carbon economy, higher labour mobility and the establishment of "physical infrastructures". The relaunch of the single market depends on its capacity to ensure "light but effective regulation", he says.

16 Mario Monti, ***A New Strategy for the Single Market at the Service of Europe's Economy and Society***, Report to the President of the European Commission, José Manuel Barroso, 09/05/2010

Europe 2020 provides the EU with an ambitious exit strategy from the crisis and paves the way for smart, sustainable and inclusive growth in the future. The success of this new strategy will depend on its capacity to address the fatal weaknesses of its predecessor, the Lisbon Agenda.

The first challenge is to guarantee an effective monitoring of the Europe 2020 strategy. The eurogroup is de facto the place where such monitoring should be conducted for eurozone members. Van Rompuy has proposed that the surveillance framework be complemented with a system of incentives for member states to achieve Europe 2020 objectives.

> *"The EU growth agenda should include reform of the single market, following the recommendations of Mario Monti who proposes to build a "stronger single market" based on support for a more resource efficient and low-carbon economy, higher labour mobility and the establishment of "physical infrastructures"*

The ambitious targets of the Europe 2020 strategy also pose the question of the financing of flagship projects. The EU budget remains small and will certainly not increase through the contributions of member states. This leads to the question of whether the time has come for the EU to levy its own taxes.

6 Eurozone's crisis and global economic governance

6.1 The eurozone in a multipolar world

The recent crisis of the eurozone provides a strong warning on the enormous complexity of managing international policy systems and dealing with crises in globalised economies.

The sovereign debt crisis revealed the potential repercussions of persistent imbalances and inequalities among countries which have insufficiently convergent economic policies.

Real and financial imbalances are mutually reinforcing, building tensions among the members of an international system and producing bubbles or widening deficits that set in motion speculative movements destabilising the entire system. The train of events leading to the Greek crisis started with the weakening of competitiveness and a growing external deficit which prompted increased borrowing by private and government sectors and, eventually, to indebtedness and the risk of sovereign default.

The subprime loan crisis in the United States can be traced to a persistently large external deficit, reflecting adverse productivity trends as well as the overvaluation of the renminbi, which fuelled excessive lending to the housing sector and, through the resulting bubble, provoked the biggest recession of the post-war period.

It has been shown in the previous section that the only effective recipe for preventing, or addressing, imbalances and creating conditions for stability and growth is enhanced cooperation and integration among policy systems with a view to securing discipline and cohesion in setting objectives and using instruments to achieve them.

In the case of the eurozone, the Greek crisis has highlighted the fact that the euro is a monetary union but not a political union. It does posses a central bank, but not a Treasury. The central bank can provide liquidity in times of crisis, though only a Treasury can address problems of solvency.

In the context of a federal system, such as the United States, there are mechanisms combining assistance with sanctions so as to either prevent or manage default, and thus ensure financial stability. The absence of such mechanisms within the eurozone, underlined by the "no bail-out" clause of the treaty, makes the euro, as well as the sovereign debt of its constituent parts, tempting targets for speculative attacks. Markets take bets on the endurance of the system.

Unless the eurozone develops institutions and procedures designed to transform it into a fully-fledged economic union, the future of the euro will remain clouded in uncertainty.

Radical reform is urgently needed in order to reinforce fiscal discipline with a view to creating a fiscal union, integrate the authorities that regulate, supervise and guarantee the financial system and set up bail-out mechanisms for handling crises. At the same time, policies should be developed to raise productivity and enhance the area's competitiveness.

The lessons drawn from the eurozone's crisis are of obvious relevance for the governance of the global economy. Globalisation is redrawing economic frontiers across the world, defining old and new poles of power while large sections of populations continue to live in conditions of extreme poverty marked by malnutrition and widespread disease. Despite clear progress indicated by the emergence of new economic powerhouses, such as China and India, inequalities and imbalances persist and, in some cases, even increase, thereby posing a serious danger to the stability of the global economy. Conflicting macroeconomic policies, particularly as regards demand management and exchange rates, produce substantial imbalances in external accounts that exert a destabilising influence on financial systems. Competing trade interests distort flows in ways that penalise to a greater degree developing countries relying on a restricted

number of export crops. Financial difficulties and ideological inhibitions impose severe limits on aid volumes, thereby delaying efforts by developing countries to combat poverty and disease.

Global economic governance is failing. Tensions are being built up between rich and poor countries while the persistence of large external imbalances, on account of uncoordinated demand and exchange rate policies, destabilise financial flows creating crisis conditions both within the countries concerned and globally.

In the following parts of this section we shall present the main problems facing the international economic system and suggest possible lines of action – at the G20 level – for reinforcing global economic cooperation and creating effective instruments in order to coordinate macroeconomic policies, promote financial reform, secure openness in trade and end poverty.

6.2 Imbalances and Inequalities

The world is a closed economy. The current account deficits of profligate countries are possible because other countries run current account surpluses. Zsolt Darvas (2010) explains that "in an ideal world" emerging economies should have current account deficits and advanced economies should have current account surpluses. Moreover, in such a world, savings should flow from capital-rich countries to capital-poor countries (Pisani-Ferry, 2009). But this is not the scenario that has prevailed in the world economy over the last fifteen years. In fact, emerging countries have had large current account surpluses, whereas developed economies have accumulated sizeable deficits. This has led to the build up of tremendous imbalances in the world. In addition, capital has flown the "wrong way", that is to say, from the developing world to advanced economies, destabilising the financial system and eventually leading to the economic crisis.

Table 6 displays the current account balances of major advanced economies and developing regions from the end of the 1990's. In 1997, advanced economies had a current account surplus of $68bn, while developing economies had a current account deficit of $70bn.

More than a decade after, current account positions reversed, and in 2009, advanced economies had a deficit of $147bn., while developing countries had a surplus of $322bn.

These figures hide important inequalities within each group of countries. Within advanced economies, the United States has run large deficits over the last decade, while the eurozone (except for 2000 and 2008-2010) and Japan have run surpluses, which were of significant size in the case of Japan. Within the group of developing countries, Asia, the Middle East and North Africa have accumulated large current account surpluses.

Table 6: Summary of Balances on Current Account (bn. of U.S. dollars - 2009)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Advanced economies	68	22	-107	-270	-222	-217	-219	-220	-410	-450	-348	-529	-147	-185
United States	-140	-214	-300	-417	-398	-459	-522	-631	-749	-804	-727	-706	-418	-487
Eurozone	92	53	32	-36	7	48	43	117	45	48	47	-106	-44	-5
Japan	97	119	115	120	88	113	136	172	166	170	211	157	142	150
Others	20	63	46	64	82	82	123	122	128	136	121	126	173	157
Developing economies	-70	-106	-15	93	48	80	149	222	450	666	658	709	322	420
Central and eastern Europe	-17	-16	-24	-29	-11	-19	-32	-53	-58	-87	-133	-152	-38	-63
Developing Asia	11	50	40	42	39	67	85	93	167	289	415	424	319	350
Middle East and North Africa	15	-26	14	78	46	31	64	106	219	286	279	348	35	119
Sub-Saharan Africa	-7	-16	-12	2	-5	-13	-13	-8	-3	31	10	9	-18	-17
Western Hemisphere	-66	-91	-57	-49	-54	-16	9	21	37	50	15	-27	-19	-47
Others	-6	-7	24	48	33	30	36	64	88	96	72	107	43	79

Source: IMF, World Economic Outlook (April 2010) - *Projections

Regarding capital movements, we observed in the last decade an unusual pattern of saving flows in the world economy. Poor countries, chiefly China, have been financing rich ones, such as the United States (Pisani-Ferry, 2010a). This is surprising because developing countries are characterised by fast productivity growth and should attract capital inflows, while developed countries characterised by slower productivity growth should show capital outflows (Gourinchas & Jeanne, 2007).

Part of the explanation for these atypical capital flows is to be found in the traumatic experiences of the early 1980's Latin American crisis and the late 1990's Asian crisis. Developing countries have accumulated foreign currencies reserves as a form of self-insurance against the risk of "sudden stops" in capital flows. As shown in table 7, developing Asia and countries from the western hemisphere, including Brazil and Mexico, have considerably increased their level of reserves over the period 2002-2009. In the case of China, some have argued that the country deliberately maintained an undervalued currency as part of an export-oriented growth strategy, intended to absorb surplus labour coming out of agriculture (Portes, 2009).

Table 7: Emerging and Developing Economies Reserves (bn. of U.S. dollars)

	2002	2009	2010*
Central and Eastern Europe	93	288	309
Developing Asia	497	2 998	3 446
Western hemisphere (including Brazil and Mexico)	160	555	604

Source: IMF, World Economic Outlook (April 2010) - *Projections

This "global savings glut", as described by Ben Bernanke, is the real cause behind the financial crisis that struck the world in 2007. In fact, the Chairman of the United States Federal Reserve explained in a recent speech that "it is impossible to understand this crisis without reference to the global imbalances in trade and capital flows that began in the latter half of the 1990's" (Bernanke, 2010).

The excessive reserve accumulation by emerging and developing economies has made global imbalances easy to finance. The massive capital flows to the United States, mainly from China, has helped maintain low long-term interest rates without an increase in domestic savings. Thus, economic policies followed in some emerging and developing countries have contributed to the United States' ability to finance its unsustainable housing bubble.

IMF projections for 2010 (Table 6) reveal that the gap between advanced economies and developing countries will broaden, as compared to 2009. Indeed, the United States' current account deficit will further increase, whereas developing Asia's surplus will expand. The eurozone's current account position will be close to balance in 2010, because Germany's large surplus will be offset by the deficits of Spain, France and Italy. For this reason, European leaders refuse to take action at the global level and continue to regard global imbalances as the responsibility of other countries, particularly blaming the United States and China (Annunziata, 2010b).

"In the emerging world, the situation of public finance is fundamentally different. Developing countries have been severely hit by the capital flow reversal following the collapse of world trade, but their banks remained relatively immune from toxic assets"

But the euro area might become part of the problem. In fact, fiscal consolidation in peripheral member states, and euro depreciation against the dollar, may push the eurozone back to an external current account surplus position.

In the emerging world, the situation of public finance is fundamentally different. Developing countries have been severely hit by the capital flow reversal following the collapse of world trade, but their banks remained relatively immune from toxic assets. Moreover, the fiscal challenge for these economies is, according to Jean Pisani-Ferry, "of much lower magnitude than in the advanced world", especially given their much faster potential growth (Pisani-Ferry, 2010a).

What if Europe enters into a phase of budgetary adjustment, while the United States' current account deficit continues to worsen and the emerging world keeps accumulating surpluses? The result would be larger imbalances and serious repercussions for the world economy. Jean Pisani-Ferry (2010a) distinguishes three main consequences. First, there would be a "significant drag on world growth", whatever the emerging world does to sustain domestic demand.

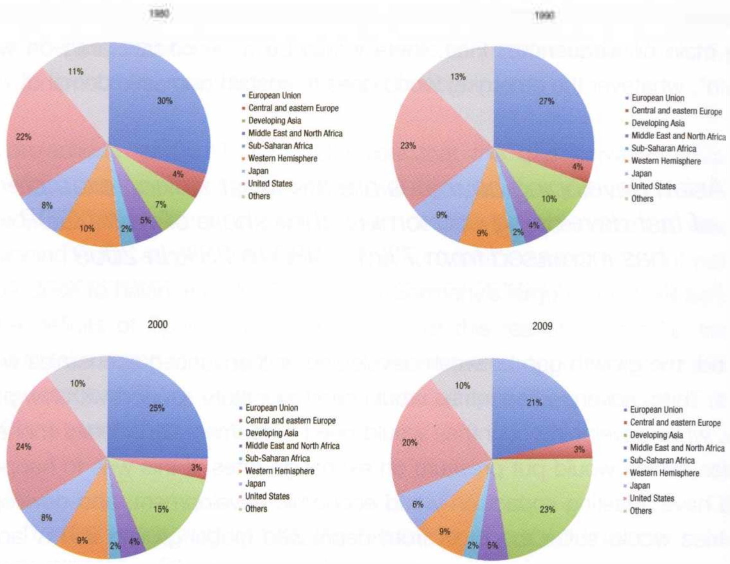
"Asian developing countries are the most striking example of fast developing economies, their share of world GDP has increased from 7% in 1980 to 23% in 2009"

Second, the growth gap between developing and advanced economies would widen. Third, advanced countries would need monetary support with low policy rates, while developing countries would need fundamentally different monetary policies, which would put pressure on exchange rates. If this was to happen it could have a lasting impact on world economic development, and developing countries would suffer the most from depressed global growth and a lack of international coordination.

Globalisation has changed the face of the world economy, transforming the structure of world GDP and permitting the emergence of new economic powers. But globalisation has not benefited all economies equally, and countries are still characterised by tremendous inequalities in terms of economic development.

Asian developing countries are the most striking example of fast developing economies, their share of world GDP has increased from 7% in 1980 to 23% in 2009 (Graph 29). Over the same period of time, the share of world GDP of several advanced economies has decreased, including the shares of the European Union and the United States.

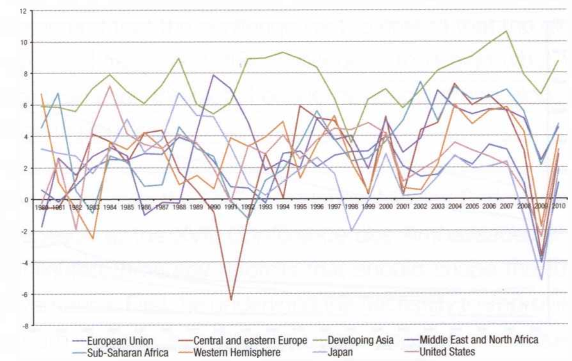
Graph 29: Share of World Gross Domestic Product based on Purchasing Power Parity (%)



Source: IMF, World Economic Outlook (April 2010)

In this context, it is relevant to consider the relative rates of growth among major economic blocs. Developing Asian countries have enjoyed the highest GDP growth rates of the past decades (Graph 30). Other emerging powers, such as western hemisphere countries or the Middle East and North Africa, have had comparatively smaller growth rates, yet still higher than advanced economies since 2000.

Graph 30: Gross Domestic Product, Constant Prices (% change)



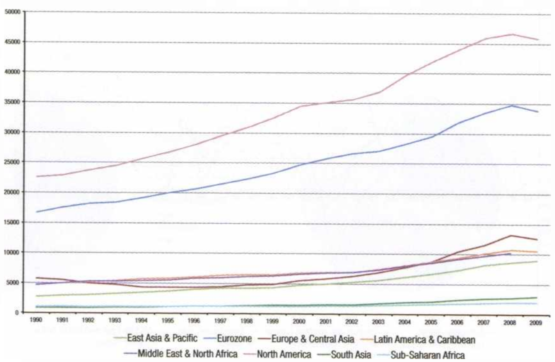
Source: IMF, World Economic Outlook (April 2010)

Despite these relatively high economic growth rates, emerging and developing economies still lag behind in terms of economic development. Data on Gross National Income (GNI) show that world economies have not benefited equally from globalisation (Graph 31). In 2009, East and Central Asian countries had a much higher GNI per capita than Southern regions. Middle East and North African countries also enjoyed higher GNI per capita than Sub-Saharan regions.

In a recent publication, the World Bank highlighted the highly positive correlation between income per capita and a wide range of development indicators, notably the poverty headcount ratio (World Bank, 2010). Thus, economic development is a key element in the combat against poverty.

The only effective recipe for addressing these issues is deeper cooperation at the global level. In the following subsections, we shall see that the G20 is the most appropriate place to deal with macroeconomic imbalances and lead the fight against inequalities. Building from its experience, the EU should take a more prominent role in global economic governance and put forward an ambitious reform agenda for the G20.

Graph 31: Gross National Income per capita*, Purchasing Power Parity (current international $)



* for Europe and Central Asia, data covers only developing countries.

Source: World Bank

Commentary — **Daniel Daianu**, former Romanian Finance Minister and former Member of the European Parliament

"In order to regain financial stability a return to the initial logic of the Bretton Woods arrangements is needed. The financial policy trilemma would mean releasing monetary policy and trade flows from the vicissitudes created by unconstrained financial flows. The currency war underway and rising protectionism are additional indications that new international arrangements are badly needed if a relatively open global system is to be preserved.

Who should impose a common denominator in the G20 is a big issue. Previous international regimes relied on the influence and arm-twisting of a superpower. In a multi-polar world this is much harder to achieve. The EU could use its soft power to the extent that it improves its internal governance. This is a litmus test for the Union and a demonstration effect for the world.

Some might ask if the US and Europe can afford to split up large financial groups at a time when Asian financial entities appear to be gaining a competitive edge in the wake of the current crisis. This has to be seen in relation to the regulatory arbitrage argument. But it would be wrong to jeopardise the functioning of entire economies for corporate benefits which are, in the end, uncertain. In addition, why would Asians ignore the lessons of the current crisis, which has worldwide implications? And why should the G20 and the Financial Stability Board not help major countries see eye-to-eye in this regard?"

6.3 Reinforcing Global Economic Cooperation

"A year ago it seemed that the challenge was to ensure that the global economy could still have a future … now the challenge is to design what this future will look like; more than ever, the global economy needs strong global leadership" – Marco Annunziata (2010a).

In 2011, France took over the G20 presidency. Nicolas Sarkozy put forward his agenda in a speech at the XVIII *Conférence des Ambassadeurs*[17]. The French President highlighted three key reforms that should shape the future of global economic governance. First, he underlined the necessity to improve the monetary system and curb excessive exchange rates. Second, he suggested tougher regulations of commodity markets, and proposed the creation of international mechanisms to reduce price volatility. Third, he expressed his support for the establishment of a G20 permanent secretariat.

The EU should seize the opportunity to make its own proposals for reforming global economic governance. Europe is a key player in the multilateral system, and is strongly represented in international institutions. Moreover, the EU has acquired considerable experience in designing supranational institutions and should use this knowledge to put forward an ambitious agenda of reforms. The EU is aptly perceived as a "laboratory" for what the world economy could look like in the future (Ahearne, Pisani-Ferry, Sapir, & Véron, 2006). Building from its experience of the eurozone's crisis, the EU should take the lead and assume a more prominent role in global governance.

Global economic governance is pertinently defined by Jean-Claude Trichet as the "set of supra-national institutions and laws as well as the international relations between countries that have an effect on cross-border economic and financial transactions" (Trichet, 2010).

17 Nicolas Sarkozy, Speech at the XVIII *Confe rence des Ambassadeurs*, Palais de l'E lyse e, 25/08/2010.

We can distinguish three major supranational institutions responsible for global economic governance: the IMF, the World Bank and the WTO. They are in charge of the international financial system, economic development and trade respectively.

The main forum for "strategic global impulse" has long been the Group of seven industrialised nations called G7. But in 2009, the G7 was officially replaced by the G20 as the "new permanent council for international economic cooperation" (CNN, 2009). The G20 process started in 1999, as an informal gathering of finance ministers and central bank governors in the aftermath of the Asian crisis. It was first organised at the level of heads of state in Washington on November 15, 2008.

"Despite this failure to promptly detect and address the underlying causes of the crisis, the G20 remains the best forum to shape the future of the world economy. It constitutes a framework for including emerging markets in the reform of world economic governance and imparting a greater legitimacy to the multilateral system"

The Group of Twenty has actively contributed to containing the financial crisis and coordinating its members' actions in order to avoid protectionism and organise fiscal responses. But the G20 has failed to address the problems at the core of the crisis, namely the real and financial imbalances that built up over the last decade. The Group of finance ministers and central bank governors should have kept an eye on macroeconomic developments, in particular exchange rate policies and current account positions.

Despite this failure to promptly detect and address the underlying causes of the crisis, the G20 remains the best forum to shape the future of the world economy. It constitutes a framework for including emerging markets in the reform of world economic governance and imparting a greater legitimacy to the multilateral system. As Barry Eichengreen (2009) aptly said, the G20 should act as a "steering committee" for the world economy, and the EU should take its chance to be in the driver's seat.

The lessons of the eurozone's crisis are of obvious relevance in this context and they should shape the EU's G20 reform agenda. The cracks in the euro area's economic governance exposed the danger of real and financial imbalances, and highlighted the fact that solidarity is unavoidable between members of an integrated policy system. At the world economy level, addressing global imbalances implies two key points:

- Reinforcing the coordination of economic policies.
- Reforming the global financial system.

6.3.1 Policy Coordination

Conflicting economic policies have produced substantial imbalances in the world economy over the last decades. Addressing these imbalances requires better coordination between G20 leaders, particularly as concerns demand management and exchange rate policies. The G20 should keep an eye on key countries' economic policies and warn against developments that could contribute to global instability.

In March 2009 at the G20 Pittsburgh Summit, finance ministers and central bank governors decided to launch a *Framework for Strong, Sustainable, and Balanced Growth*. This framework lays the foundations for a cooperative mutual assessment of G20 members' economic policies. According to Jean-Claude Trichet, it is an important step to address "one of the main shortcomings of the pre-crisis regime", namely the lack of instruments to ensure that major economies take into consideration their policies' external spillovers (Trichet, 2010). This surveillance mechanism should be used to evaluate the long-term viability and compatibility of key countries' economic policies, especially regarding exchange rates and fiscal positions.

To ensure effective coordination of economic policies, G20 leaders should endorse the creation a permanent secretariat. This would make policy proposals and provide orientation with regard to macroeconomic and financial developments. The secretariat should actively cooperate with the IMF to benefit from its analysis, notably regarding exchange rates.

Today, G20's activities are coordinated by a "troika" of past, present and future chairs. But this mechanism does not permit long-term strategic thinking. A permanent secretariat could prepare the summits and monitor the implementation of commitments (Carin, Heinbecker, Smith & Thakur, 2010).

According to Carin et al. (2010), the challenge will be to find "the correct balance of formality", because informality has been key to the success of the G8 and the G20. For this reason, the structure of the secretariat should be light. Moreover, the existence of a heavy secretariat structure would undermine the commitment by national officials to the G20 process (Carin, Heinbecker, Smith & Thakur, 2010).

Johannes Linn (2010) has proposed that the secretariat be convened at three-year intervals in the capital of a troika country. Carin et al. (2010) has suggested that it be composed of seconded personnel from the three troika countries and headed by their "sherpas". This would allow the rotating presidency to retain political control over agendas and implementation.

The budget of the G20 secretariat should be small given that its structure is light. It could be funded in equal parts by the members of the current troika (Carin, Heinbecker, Smith & Thakur, 2010).

Addressing the problem of global imbalances also implies limiting foreign currency accumulation in developing countries, which has primarily been achieved through large current account surpluses and undervalued exchange rates. However, the sudden stoppage in capital flows that occurred during the crisis convinced emerging economies that they need more insurance against volatility, in other words that they should continue to accumulate foreign currencies reserves (Eichengreen, 2009).

But why do developing countries use this "individually costly and collectively inefficient way" to protect against shocks? The answer is that they do not trust the multilateral insurance agency: the IMF (Pisani-Ferry & Santos, 2009).

G20 leaders should thus work on rebuilding confidence in the IMF to avoid further increases in foreign currency reserves. They should decide to increase the Fund's resources, because the limits on its loans are "way too low" for emerging economies to deal with contemporary economic shocks (Goldstein, 2009). Indeed, the recent financial turmoil has highlighted the fact that emergency lending to globalised countries requires considerably larger resources than in the past (Wyplosz, 2009).

Finally, reinforcing policy coordination will require the full commitment of developing economies. For this reason, G20 leaders should agree to increase their representation in international economic institutions, notably the IMF, where advanced economies are over-represented.

Today, emerging markets represent about one third of world GDP at nominal exchange rates, and close to a half in Purchasing Power Parity (Trichet, 2010); and this proportion is likely to increase over the next ten to twenty years. Adequate reforms should take into account this trend.

Since 1992, the IMF has increased its executive board from 20 to 24 seats, with the supplementary seats aimed at increasing the representation of developing countries. More recently, in November 2010, the fund has decided a redistribution of 6% of voting rights in favour of dynamic emerging markets.

But these measures have barely changed the balance of power between advanced and emerging countries in the IMF. The G20 should push for further reform otherwise the fund will continue to be seen as an instrument of "yesterday's powers" (Pisani-Ferry, 2009).

The united states has forced the debate by refusing to re-elect the 24-member board in September 2010. It justified the move as a support for increasing developing countries representation. In fact, IMF's Executive Board adopted, on November 4, proposals to double the quotas and realign quota shares in favour of emerging market and developing countries. The proposals represented steps in the right direction but fell short of the necessary realignment.

The package should include a single seat for the eurozone, and a decrease of Europe's voting rights. At the same time, as suggested by Wolfgang Schäuble, the Fund should decide to reduce the supermajority for important decisions from 85% to 75%, which would automatically remove the U.S. veto power.

With this reform, the EU would actually raise its influence in the IMF. Indeed, its over-representation was often diluted by divergent national interests and a single seat would oblige its members to speak with one voice. Moreover, a pooling of IMF quotas would give the EU a larger quota than that of the U.S. The Seoul G20 Summit approved the proposals of the IMF's Executive Board going some way to enhance the credibility and the effectiveness of the Fund. However, the EU should push the G20 to implement more radical reforms in the near future.

These ambitious measures, namely strengthening economic policy coordination, restoring the multilateral insurance system and increasing the representation of emerging economies, should lay the foundations for enhanced global economic governance and would reinforce cooperation between key world economies. The challenge is to link the Group of Twenty and the existing international institutions in order to create a "stronger and more legitimate governance of globalisation" (Pisani-Ferry & Santos, 2009).

6.3.2 Financial Reform

The crisis has provided the impetus for major financial reforms in advanced economies. The EU has endorsed the de Larosière recommendations creating new supervisory authorities. President Obama has signed into law the Dodd-Frank Act overhauling the U.S. financial system. G20 leaders should now turn to global issues and work at ensuring a level playing field in financial regulation and supervision.

Building on its experience, the EU should actively contribute to setting the global financial agenda. In particular, the EU should support a radical reform of microprudential regulation and macroprudential supervision, as well as promote the development of resolution mechanisms for cross-border financial institutions.

The challenge is to establish a globally consistent set of rules that would lay the foundations for sustainable economic growth and reduce the impact of future crises. The G20 should put forward guidelines for regulating and supervising financial markets and propose a "cross-border resolution framework" (IMF, 2010a).

Coordination at the global level is essential in order to shape a new financial system that is more resilient and geared towards long-term sustainability. The EU should support an ambitious reform agenda for the G20 aimed towards three key issues:

- Ensuring a level playing field in regulation in order to avoid cross-border arbitrage.
- Improving financial supervision to deal with cross-border institutions.
- Promoting internationally consistent resolution mechanisms to address the problem posed by banks "too big to fail".

Microprudential regulation should make individual financial institutions more resilient. In this context, the recent decision of the Basel Committee on Banking Supervision to increase capital and liquidity requirements (developed in subsection 5.2) goes in the right direction. This should provide financial institutions with a stronger buffer against future shocks.

Beyond capital requirements, the G20 should encourage regulatory reform of financial instruments and practises, such as naked short selling or Credit Default Swaps. Global coordination is necessary to create a level playing field and avoid that financial institutions migrate to less regulated countries.

Reform of microprudential regulation should be designed to target the entire financial system, that is, banks and non-banks alike, to avoid riskier products being transferred to unregulated segments of the system.

Financial regulation must be complemented with effective macroprudential supervision. In this regard, it is critical that supervisory authorities are given adequate resources and powers to identify, monitor, and enforce regulatory compliance so as to limit excessive risk taking.

At the G20 level, leaders should adopt guiding principles for the supervision of cross-border institutions in order to improve the transparency of the system and make it more predictable.

The IMF and the newly created Financial Stability Board (FSB) could play a key role in this regard. The two bodies can provide an early warning system regarding macroeconomic and financial risks, and eventually suggest mitigating actions. This joint exercise could help maintaining global financial stability and prevent a repeat of the errors preceding the crisis.

In addition to enhanced coordination in financial regulation and supervision, the G20 should put forward a "cross-border resolution framework", as suggested by the IMF (2010a). Resolution mechanisms for cross-border financial institutions aim at limiting moral hazard by making orderly default a credible option. Enhanced coordination would make the resolving of a failing international institution more rapid and more predictable.

This framework could be put in place through a nonbinding multilateral understanding reached among national authorities (IMF, 2010a). Supervisory authorities in participating countries would coordinate their resolution efforts to the maximum extent possible and follow agreed principles for the burden sharing process.

The challenge is to ensure that financial institutions that are "global in life" do not become "national in death" (IMF, 2010b). For this reason, the limited group of countries that are home to major financial centres should rapidly adhere to common standards for regulation and supervision and make the resolution framework detailed above operational.

6.4 Poverty, Openness and Aid

"It is clear that improvements in the lives of the poor have been unacceptably slow, and some hard-won gains are being eroded by the climate, food and economic crises", wrote Ban Ki-Moon in the foreword of the 2010 Millennium Development Goals Report.

The financial and economic crisis did have a severe impact on the economic development of emerging and developing countries. Estimates from the World Bank suggest that the crisis has left an additional 50 million people in extreme poverty in 2009 and a further 64 million will join them by the end of 2010, relative to a no-crisis scenario (UN, 2010a).

But the explanation for the poor results in the fight against world poverty is also to be found in the failure of advanced countries to actively contribute to reducing world inequalities. Developed economies should make globalisation more profitable to emerging economies and should improve their aid policies towards developing countries.

"Estimates from the World Bank suggest that the crisis has left an additional 50 million people in extreme poverty in 2009 and a further 64 million will join them by the end of 2010, relative to a no-crisis scenario"

6.4.1 Improving Developing Countries Trade Environment

At the Washington Summit, in November 2008, G20 leaders pledged to refrain from protectionist policies. The final declaration read: "We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing WTO inconsistent measures to stimulate exports".

This is a noble statement, but it did not turn out to be an effective instrument. Major economies did implement protectionist measures that were not in violation of any WTO obligations. Richard Baldwin and Simon Evenett (2009) describe these measures as "murky protectionism", and give the examples of health and safety regulations, or stimulus package clauses that restrict spending to domestic producers. We can also think of WTO protective arrangements, such as antidumping measures, anti-subsidies, or safeguard tariffs, which have been widely used during the crisis (Bown, 2009). The Global Trade Alert initiative reported on its website of 390 trade-damaging measures by G20 members from November 2008 to December 2009. Over the same period, G20 economies passed only 56 measures beneficial to importers (Trichet, 2010).

G20 leaders should take immediate action that goes far beyond what has been decided at the Washington Summit, because protectionist measures threaten decades of trade negotiations under the WTO. Should the opposite occur, emerging and developing countries would be the most severely hit and it would be a step backwards in the combat against world poverty. The Group of Twenty should commit to two key principles:

- To reverse protectionist tendencies.
- To improve the trading environment for developing countries.

Concretely, finance ministers in the G20 should refrain from legislating any new protectionist measures, even if they are allowed to do so under current international obligations. Peter Gallagher and Andrew Stoler (2009) suggested that G20 economies pledge "no increases in any import duties; [...] no hikes in any fees or taxes applying to imports; no new export restrictions; and no new regulatory requirements" that would restrict access to home markets for foreign suppliers. The two economists also called for a mechanism aimed at identifying potentially harmful trade measures. The monitoring could be assigned to the WTO or the OECD, as suggested by Jean Pisani-Ferry and Indhira Santos (2009).

The crisis has severely impacted emerging economies on the trade front. According to the Millennium Development Goals Report, developing countries suffered a 31% decline in the value of their exports in 2009, compared to an average world drop of 23% (UN, 2010a).

Over the last decade, advanced economies have eased access to their market for developing countries. In 2008, 81% of least developed countries' exports to industrialised markets had acquired duty-free status, excluding armaments and oil (UN, 2010a).

This has been a step forward. But it is still below the 97% threshold WTO members pledged when they met in Honk Kong in 2005. Moreover, agricultural subsidies in developed countries still represent $376bn. per year, which, according to the United Nations[18], continue to "undermine prices and income opportunities for farmers in developing countries".

The G20 should commit to further liberalisation of their trade policies to improve the trading environment for developing countries. This would help achieve the Millennium Development Goals by ensuring that developing countries benefit effectively from globalisation. In a recent publication[19], the United Nations Development Programme (UNDP) called for G20 leaders to take action in order to complete the Doha Round "by the end of 2011".

Negotiations under the Doha Development Agenda (DDA) were launched in Doha in November 2001. Subsequent ministerial meetings took place in Cancún (2003) and Hong Kong (2005), as well as several rounds of negotiations in Geneva, Paris and Potsdam, but all failed to reach a compromise.

The most recent negotiations, in Geneva in July 2008, broke down because of divergences between developed and developing countries' interests. On the one hand, developing countries pressed advanced economies, chiefly the U.S. and the EU, to agree to a further liberalisation of agriculture. On the other hand, developed countries urged emerging economies to make additional market access commitments (Hoekman, 2010).

18 United Nations, *Extra Push Needed on Aid, Trade and Debt to Meet Global Anti-poverty Goals*, Press release 16/09/2010
19 UNDP, *What Will It Take to Achieve the Millennium Development Goals?*, June 2010

Ian F. Fergusson (2008) highlights two more issues in the agenda that are of particular importance for developing countries beyond the question of agriculture.

First, the DDA aims at reviewing the special and differential treatment given to developing countries in order to strengthen its functioning. Second, it seeks to address the problems encountered by developing countries when implementing current trade obligations, notably relating to their limited technical capacity.

According to Bernard Hoekman (2010), "significant technical progress has (already) been made in identifying the contours of a possible deal", but further compromises are needed. The EU should be in the driver's seat and take initiatives to unlock these negotiations.

"Negotiations in Doha and during the subsequent meetings have secured an agreement on some key issues that would boost trade by cutting red-tape and delays at border crossings. A provisional accord would show the commitment of advanced countries to promote trade as a vehicle of economic development"

The 27 EU member states should accept they should give up on some sectoral interests, especially agriculture. Together with the United States, the EU should decide to decrease export subsidies for agricultural products, which would enable developing countries' farmers to be more competitive. Moreover, Washington and Brussels should increase the share of poorest nations' products that enter their markets duty-free. In this context, reviewing the special and differential treatment for developing countries is particularly important in order to make the provisions "more precise, effective and operational"[20].

20 Doha Ministerial Declaration, adopted on 14 November 2001.

But what if no agreement is reached on Doha within the next few years? What measures should be envisaged, at the WTO level, to make the trading environment more favourable to developing countries? Richard Baldwin and Simon J. Evenett (2008) argue that the WTO should prepare a "Plan B" in order to maintain its credibility.

This Plan B could include a provisional accord on trade facilitation (Baldwin & Evenett, 2008). This would aim at improving the efficiency of international trade by harmonising customs rules and procedures (Fergusson, 2008).

Negotiations in Doha and during the subsequent meetings have secured an agreement on some key issues that would boost trade by cutting red-tape and delays at border crossings. A provisional accord would show the commitment of advanced countries to promote trade as a vehicle of economic development.

Moreover, industrialised countries should decide to create a fund under the WTO to help developing countries meet the provisions of the new accord and further attempts to cut bureaucracy and delays (Baldwin, Evenett, 2008). In addition, special effort could be made to assist civil society organisations dealing with trade issues in least-developed countries, especially in Africa (Peter Sutherland et al., 2004).

"The 27 EU member states should accept they should give up on some sectoral interests, especially agriculture. Together with the United States, the EU should decide to decrease export subsidies for agricultural products, which would enable developing countries' farmers to be more competitive"

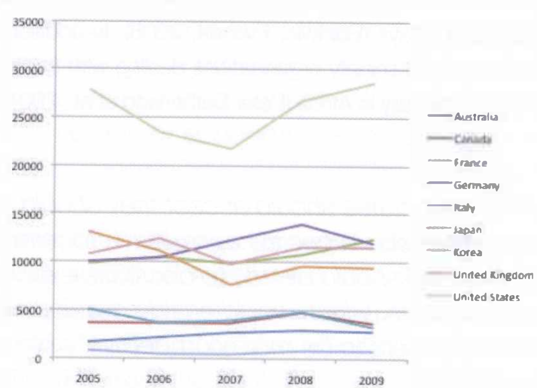
Finally, the WTO should respond to the erosion of the non-discrimination principle. In fact, governments are increasingly using preferential treatment to pursue non-trade related objectives. As a result, most-favoured-nation treatment is close to becoming exceptional treatment. The WTO should test any new initiative to see if it clearly improves trading and development prospects of beneficiaries and does not harm the interests of those outside (Peter Sutherland et al., 2004).

6.4.2 Improving Official Development Assistance

In 2005 at the Gleneagles Summit, G8 leaders agreed to double global aid by 2010, with half of the increase in funds secured for Africa. In numerical terms, it represents an increase of Official Development Assistance (ODA) by $50bn. with $25bn. going to Africa (UN, 2010b).

Graph 32 shows ODA net disbursements from a selected number of advanced G20 economies. We observe tremendous differences in the amount of aid expenditure from one country to another. In 2009, the United States is the biggest donor, followed by France, Germany, the United Kingdom and Japan. Canada, Italy, Australia and Korea lag well behind.

Graph 32: Official Development Assistance (current prices - millions of U.S. dollars)



Source: OECD

Although ODA is expected to rise to $126bn. in 2010, it will not be enough to meet the targets agreed in Gleneagles (UN, 2010b). In that sense, G8 countries have not kept their promises to reduce inequalities and help poorer nations.

So what should we expect from the G20? Can it do better than its predecessor with regard to development assistance? All heads are now turned to the next challenge, namely the Millennium Development Goals, and G20 leaders will need to respond to these expectations by taking significant actions.

Kemal Dervis et al. (2010) wrote in a recent article that the G20 will bring a "fresh perspective to the development agenda", which should benefit the world's poorer countries. Korean President, Lee Myung-bak, confirmed their expectations by deciding to include development as an "integral part" of the G20's mission (Dervis et al, 2010).

"The EU is particularly active in economic assistance, helping more than 160 countries, territories or organisations worldwide. Building on its experience, the EU should put forward an ambitious agenda for the G20 that would enable the Millennium Development Goals to be reached"

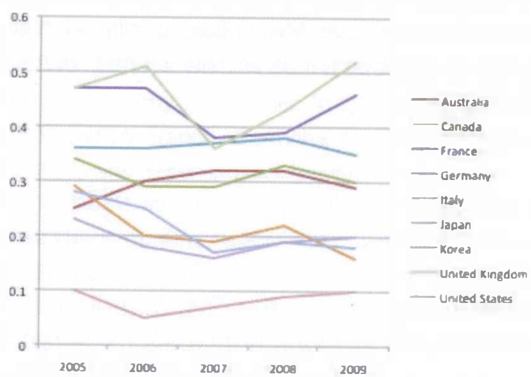
The EU is particularly active in economic assistance, helping more than 160 countries, territories or organisations worldwide. Building on its experience, the EU should put forward an ambitious agenda for the G20 that would enable the Millennium Development Goals to be reached. In particular, this should focus on two key issues:

- Increasing official development aid and promoting innovative financing.
- Coordinating economic assistance and reinforcing mutual accountability.

In 2000 at the United Nations, advanced economies pledged to dedicate 0.7% of their Gross National Income (GNI) to ODA by 2015. Today, only five countries, none of them members of the G20, have reached this objective, namely Sweden, Norway, Denmark, Luxembourg and the Netherlands. The G20 should push its members to keep their promises to reach the 0.7% target within the next five years.

Graph 33 shows that a majority of G20 members, with the exception of the United Kingdom and France, spend less than 0.4% of their GNI on ODA. Thus, in order to keep their promises, G20's most advanced economies will need to drastically increase their contribution to world development assistance.

Graph 33: Official Development Assistance (current prices in % of GNI)



Source: OECD

In the wake of the financial and economic crisis, several developed countries have reduced their contribution to ODA (Graphs 32 - 33). Even though this decline has been temporary, major advanced economies are now under budgetary pressure, so the time may have come to think about new sources of financing. France, Chile, Brazil, Norway and other developed and emerging countries, are in favour of innovative sources of financing to help reach the United Nations' Development Goals. There are different proposals, with some heads of state arguing for the benefits of a financial transaction tax or levies on airline tickets. Innovative financing would be an important instrument to increase resources for development, but the UNDP warned that it should not "fragment the aid architecture further or distract attention from traditional ODA" (UNDP, 2010).

In addition to aid volumes, the G20 should raise effectiveness of development assistance by improving coordination between donor countries and reinforcing mutual accountability.

The past decade has shown the limitations of bilateral aid. Individual donors tend to channel their aid to isolated projects for which they can claim credit, which has proved to be demonstrably inefficient. Indeed, recipient countries cannot create unified national plans to combat, for instance widespread diseases, with fragmented bilateral programmes.

This led Jeffrey Sachs (2010) to claim that bilateral aid is "broken", adding that world leaders should agree to put more emphasis on multilateral aid. Pooling resources would help to reduce excessive fragmentation of bilateral programmes and minimise transaction costs. Moreover, multilateral assistance would avoid the duplication of development programmes implemented by individual donors.

The Global Fund to Fight Aids, Tuberculosis and Malaria (GFFATM) is a striking example of the advantages of a multilateral programme. The fund has helped to save millions of lives in more than 140 countries by pooling together resources from many donor nations. The GFFATM is supervised by an independent review board that approves national programmes according to scientific criteria rather than bilateral politics (Jeffrey Sachs, 2010). Thus, multilateral aid enhances transparency by reducing political influence. At the same time, G20 countries should reinforce mutual accountability, whether it is accountability between donors or accountability between donors and recipients. This would raise the effectiveness of development assistance and further improve aid transparency.

At the last United Nations summit in New York in September 2010, Barrack Obama suggested to reward efficient users with more say in the way they use aid funds. His idea was to allow "well-run recipient countries" to decide their own spending plans, which would then be funded by several donors (FT, 24/09/10).

The U.S. President insisted during his speech[21] on the need for "more responsibility" on the part of developing countries, because there is, according to him, "no substitute for (their) leadership".

21 Barack Obama, Remarks at the Millennium Development Goals Summit in New York, 22/09/2010.

Postscript

By Paul Taylor, *Associate Editor,* Thomson Reuters

This is an ambitious effort to frame a comprehensive set of proposals for reshaping European and global economic governance. Yet Papantoniou's proposed remedies – common Eurobonds, a European solidarity fund for debtor countries and more fiscal transfers from a self-funded European budget – seem to confirm the adage that "where you sit is where you stand".

The reader searches in vain for any acknowledgement of the policy mistakes of the southern euro area countries, depicted as victims of rather than responsible for their loss of competitiveness over the euro's first decade, whereas Germany incurs only blame and no credit for having addressed its own loss of competitiveness, fiscal and demographic challenges by policies of wage restraint, labour market and welfare reform that fuelled an economic revival in the mid-2000s.

It is unrealistic to ask northern European countries with the best credit ratings to issue joint Eurobonds, pour their taxpayers' money or guarantees into a permanent fund to bail out euro zone countries in trouble, and also grant the European Union tax-raising powers to swell a federal budget, enabling larger transfers to southern euro zone states.

The author does not consider whether common Eurobonds would raise the borrowing costs for countries such as Germany, the Netherlands and France. He appears to assume improbably that Eurobonds could be issued for all at German yields. Nor does he consider proposals such as Delpla and von Weizsaecker (Bruegel 2010) for using joint bond issues to increase fiscal discipline on high-debt countries by limiting each state's access to the part of its debt within the EU reference value.

These reservations do not negate the value of some of Papantoniou's proposals, notably for a single euro zone seat in the IMF (why not also in the G20?), which would permit a rebalancing of seats and votes in favour of emerging nations and enable Europe to wield more collective influence. However, Europe will not speak credibly with a single voice in global financial institutions if it is incapable of agreeing on an objective account on how it got into the current mess.

Paul Taylor, *Paris, April 2011*

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Appendix A: Eurozone's History and Institutions

Antecedents of the EMU

The first attempt to create an Economic and Monetary Union (EMU) goes back to the summit of The Hague in 1969. With the threat of collapse of the international monetary system, namely the Bretton Woods regime, European Community member states were seeking monetary stability, anticipating the possible issues related to a world with flexible exchange rates.

As a response to the final communiqué of the conference, Luxembourg Prime Minister, Pierre Werner, invited his counterparts to meet and agree upon a plan of action. The Werner Plan proposed to reduce the fluctuations between the community currencies, as well as between these currencies and the dollar. When the member states of the European Community (EC) decided on 12 April 1972 to put in place the "snake in the tunnel", the decision was taken to limit the fluctuations, between the EC currencies, to more or less 2.25% (the snake), and of these currencies with the dollar to 4.5% (the tunnel) (EP, 2007).

However, this first attempt was abandoned relatively quickly due to the impact of the oil shocks, which obliged most member states to leave and rejoin the exchange stability mechanism several times during the 1970's.

The second forerunner of the European Monetary Union was the European Monetary System (EMS). During the Brussels Summit of December 1978, heads of states or government decided to set a framework for the fluctuations between the currencies of the member states in order to create a zone of monetary stability in Europe.

The EMS came into force on 13 March 1979 and created a system of fixed but adjustable exchange rates between the currencies of the participating countries. At the core of the EMS was the European Currency Unit (ECU), consisting of a basket of European currencies, with a weight attached to each currency, reflecting the share of the national economy in the Community Gross Domestic Product. The ECU was not a legal tender, but a payment instrument between central banks, as well as an accounting currency to specify the Community budget.

The relatively smooth functioning of the EMS and the ECU constituted a strong basis for further economic and monetary integration in the Community (Townsend, 2007). Impetus for deeper cooperation was provided by the report of the Delors committee[22] in 1989, and the proposal for a genuine European Monetary Union. Although the initial report had been significantly modified, it can be considered as the basis for the creation of the EMU in the context of the set-up of the European Union in the Maastricht treaty in 1992. The basic policy regime and the principal characteristics of EMU were laid down at this time.

Before describing the scope and objectives of the Monetary Union, it is worth summing up some debates that arose during the shaping of the project. Most of the questions were related to the costs and benefits of a Monetary Union for the European Union. On the one hand, a Monetary Union would allow for lower transaction costs because payments within the Union would no longer require the exchange of currencies (Eijffinger & Haan, 2000), thereby eliminating exchange rate risks. Moreover, this process would enhance cross-border price transparency and induce deeper market integration, as envisaged by the European Single Act in 1986. On the other hand, participating countries would abandon one of their main instruments of economic policy, the exchange rate, which allowed for competitive devaluation (Eijffinger & Haan, 2000).

22 European Commission, *Report on economic and monetary union in the European Community*, 1989.

The vast literature on the cost and benefits of monetary unions, going back to the famous article "A Theory of Optimum Currency Areas" by Robert Mundell, has shown that the benefits are superior to the costs when the flexibility of the labour market is high (i.e. a high degree of labour mobility and wage flexibility) and the asymmetry of shocks low among the participating countries. But, the EU did not seem to satisfy these criteria (De Grauwe, 1997).

Although these economic arguments have played a role in the debate, political considerations eventually prevailed in shaping the characteristics of the European Monetary Union.

Preparing for the adoption of the Euro, member states willing to participate in the Monetary Union were compelled to coordinate their economic policies (Articles 99 and 104 of the EC treaty) and to strive for economic convergence, i.e. by synchronising their business cycles (Art. 121 of the EC treaty). These joint efforts triggered effective economic convergence, creating a base for the implementation of the euro as the official accounting currency of all EMU members from 1 January 1999, existing in parallel to national currencies until the introduction of euro coins and notes on 1 January 2001 when the euro became the only official currency in the Monetary Union.

The policy regime agreed upon at Maastricht was "truly special and unique in featuring a federal supranational monetary authority paired with national fiscal authorities" (Bibow, 2009). To ensure that this divorce between Money and State would be successful, the founding fathers of the Maastricht regime put into place safeguards in the form of three core policies: the prohibition of public entities' privileged access to financial institutions, the ban of excessive deficits and a no bail-out clause.

The prohibition of compulsory finance of the public sector (Art. 124 Lisbon treaty) liberated financial institutions from their obligation to lend to the public sector, usually done through monetizing public debt. This was an attempt to protect the so-called "printing press" and it contributed to the creation of a genuine EU financial market in accordance with the principles of an open market economy.

The second constraint put on public financing took the form of a limitation of budget deficits. This clause was designed both to avoid negative spillover effects that can arise in a monetary union retaining national fiscal policies and to limit the "deficit bias" of national governments by tying their hands. In fact, member state's budget deficits exceeding 3% of GDP are generally considered excessive and may lead to financial penalties under the Excessive Deficit Procedure (EDP). This principle of fiscal virtue was further completed during the Amsterdam European Council in 1997 with the adoption of the Stability and Growth Pact (SGP). The latter promotes a budget in balance or in surplus over the cycle and was designed to ensure the adherence to the economic criteria of the Maastricht regime beyond the adoption of the euro.

In 2005, the Council adopted a reform of the SGP intended to strengthen the pact's implementation. The main contribution of this reform was the reinforcement of the "preventive arm" and the "corrective arm" of the SGP. These improvements aimed at reinforcing the dissuasive effect of the SGP, which turned out not to be very efficient, with sizeable deviations from the agreed threshold by some member states. This reform adopted by the Economic and Financial Affairs Council (Ecofin) completed the "preventive arm" of the Pact, focusing on structural balances and giving the possibility to adopt medium-term budgetary objectives fitting better the economic and structural specificities of member states (e.g. pension reform). The modifications of the "corrective arm" aimed at clarifying the circumstances that could lead to a waiver under the excessive deficit procedure.

The no bail-out clause was conceived to protect the member states participating in the Monetary Union from each other's fiscal indiscipline. It includes articles 123 to 125 of the Lisbon treaty. Article 123 establishes that preferential financing by the ECB and national central banks is prohibited for member states. Article 124 (mentioned above) states that privileged access to financial institutions that are not based on prudential considerations by governments is proscribed. Article 125 claims that the ECB, the Community institutions and member states are not "liable for or assume the commitments of other member states". Thus, each member state is responsible for paying its own public debt.

With the launch of the Euro, the EMS needed to be reshaped in order to integrate the new currency. This change took place during the Amsterdam Council and gave birth to a new European Monetary System (EMS II). This aims at establishing a new exchange-rate mechanism to regulate the relationship between the euro and the currencies of the member states that are not members of the Monetary Union. EMS II sets parities (and fluctuation margins) between the euro and the other currencies. The participation in the EMS II is optional, but the countries who joined the EU in 2004 and 2007, as well as Sweden, have to join the mechanism as a preparation for their later entry into the eurozone.

Regarding entry into the eurozone, 16 out of 27 member states have so far adopted the euro as their official currency. The United Kingdom and Denmark have obtained an opt-out, while the rest of the member states, including Sweden, are supposed to join the eurozone in the future. The last countries that requested entry and have been accepted were Slovenia in 2007, Cyprus and Malta in 2008, and Slovakia in 2009. Estonia is likely to become the seventeenth member of the eurozone in 2011.

Institutions of the EMU

The European System of Central Banks (ESCB), complemented by the Ecofin and the Economic and Financial Committee (EFC), govern the European Monetary System. The ESCB comprises the European Central Bank (ECB) and the National Central Banks (NCBs). Together, they are responsible for defining and implementing the monetary policy of the EMU and conducting foreign exchange operations.

The Ecofin brings together the economy and finance ministers from the 27 EU countries, with parts of its work devoted to the exchange-rate policy of the euro vis-à-vis non-EU currencies.

The ECB, the Commission, and each member state appoint two members of the EFC (Council Decision 98/743/EC). As the successor of the Monetary Committee, created in the run-up to the Euro, the EFC has roughly the same mission; to ensure the coordination of member states policies to the full extent needed for the functioning of the internal market (Article 114 EC). The EFC also prepares the work of the Ecofin.

When considering the ECB and the sole National Central Banks from the countries that adopted the euro (eurozone), one usually refers to the eurosystem. The ECB, core institution of the eurosystem, is the common central bank of the eurozone and has established itself as the "euro's guardian of stability" (Bibow, 2009). This very special role of the ECB comes directly from the Bundesbank "success story", which has been the intellectual background behind most of the ECB's guidelines.

The ECB is composed of two independent bodies, the ECB Governing Council and the Executive Board. The former regroups the members of the Executive Board, as well as the Governors of the NCBs of the countries of the eurozone (Article 10.1 of the Statute of the ECB). It is responsible for framing the monetary policy of the EMU, i.e. broadly setting the interest rates and the money supply. The Executive Board is entrusted with implementing monetary policy, respecting the guidelines set by the Governing Council. One of the tasks left to the discretion of the eurozone member states is the supervision of the banking system, as it was before the introduction of the euro.

As discussed above, the way the ECB interprets its role has been mainly influenced by the policy regime of the Bundesbank. Among the characteristics shared by the ECB with its German predecessor, we can highlight the strong price-stability oriented policy, the refusal to fine-tune the economy, and explicit independence from any political interference. This statute has been anchored in the Maastricht treaty at the establishment of the ECB and gave birth to the so-called "Maastricht regime" (Bibow, 2009).

The ECB defines price stability as "a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2 percent", and this being maintained "over the medium term" (ECB, 1999). In order to achieve this objective, the ECB controls the money supply relying on a "two-pillar stability-oriented policy strategy", with the first pillar dedicated to economic analysis of short term indicators, further cross-checked by monetary analysis of the broadest monetary aggregate (second pillar).

This primary objective pursued by the ECB is complemented by two secondary objectives: output growth levels and employment goals. However, no special attention is devoted to the achievement of these secondary objectives since for the ECB "maintaining price stability in itself contributes to the achievement of output and employment goals" (ECB, 1999).

Beyond this strategy, the ECB refuses any activist policies and fine-tuning of the economy. Thus, it usually moves fast when it comes to diminishing monetary supply but rather slowly to accelerate afterwards. The asymmetry in ECB's approach may be attributed to the influence of German central bankers over the last decades. Otmar Issing, chief economist of the ECB from 1998 to 2006, summed up this rejection of activist monetary policy arguing that "artificially stimulating the economy by large budget deficits and/or inflationary monetary policy is no viable option. In fact, history tells us that such policies can only provide temporary straw fires, with potentially damaging long-term consequences" (Issing, 2003).

The very last peculiarity of the ECB inherited from the Bundesbank is its relative independence from political actors. Indeed, the design of the European Central Bank has been such that no effective check was put in place to balance its authority. This specificity has taken the name of "Maastricht paradox", with the single currency managed by a federal supranational authority, namely the ECB, which is not accountable to any national or European political bodies. As was the German Bundesbank, the ECB has been designed as accountable only to the general public, stepping aside from any political influence.

The last formal institution of the eurozone is the eurogroup. Modelled after the Ecofin, it gathers the ministers of economy and finance from the eurozone countries, meeting regularly to discuss issues of the European Economic and Monetary Union (EP, 2007). This advisory and informal body is currently chaired by Jean-Claude Juncker. The recognition of the role of the president first appeared with the Lisbon treaty (Art. 2, Protocol 14 treaty on the Functioning of the European Union).

Appendix B: Statistics

Table 1: Real Gross Domestic Product per capita (euro per inhabitant)

	1999	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Slovakia	4000	4100	4200	4400	4600	4900	5200	5600	6200	6600	6300
Malta	:	10800	10600	10800	10700	10700	11000	11300	11600	11800	11500
Portugal	11600	12000	12100	12100	11900	12100	12100	12200	12400	12400	12100
Slovenia	10400	10800	11100	11500	11800	12300	12800	13500	14400	14900	13600
Greece	12100	12600	13100	13500	14300	14900	15200	15800	16400	16700	16300
Cyprus	14000	14500	14900	15100	15100	15400	15600	15900	16500	16900	:
Spain	15000	15700	16000	16200	16500	16700	17100	17500	17800	17600	16800
Italy	20200	20900	21300	21300	21100	21300	21200	21500	21700	21300	20000
Euro area	21700	22400	22400	22400	22500	22800	23000	23600	24000	24000	22600
France	23000	23700	24000	24100	24200	24600	24900	25200	25700	25600	24800
Belgium	23800	24600	24700	24900	25000	25700	26000	26600	27200	27200	26200
Germany	24300	25100	25400	25300	25200	25600	25800	26600	27300	27700	26400
Austria	25100	25900	25900	26200	26300	26800	27300	28100	29000	29500	:
Netherlands	25400	26300	26600	26400	26400	26900	27400	28200	29200	29700	28300
Finland	24300	25500	26000	26500	26900	28000	28700	29800	31200	31400	28800
Ireland	25500	27600	28700	30000	30800	31700	32900	33800	35000	33400	30800
Luxembourg	46900	50200	51100	52600	52800	54300	56400	58600	61500	60400	57300

Source: Eurostat

Table 2: Employment rate (%)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Malta		54.2	54.3	54.4	54.2	54	53.9	53.6	54.6	55.3	54.9
Italy	52.7	53.7	54.8	55.5	56.1	57.6	57.6	58.4	58.7	58.7	57.5
Spain	53.8	56.3	57.8	58.5	59.8	61.1	63.3	64.8	65.6	64.3	59.8
Slovakia	58.1	56.8	56.8	56.8	57.7	57	57.7	59.4	60.7	62.3	60.2
Greece	55.9	56.5	56.3	57.5	58.7	59.4	60.1	61	61.4	61.9	61.2
Belgium	59.3	60.5	59.9	59.9	59.6	60.3	61.1	61	62	62.4	61.6
Ireland	63.3	65.2	65.8	65.5	65.5	66.3	67.6	68.6	69.1	67.6	61.8
France	60.9	62.1	62.8	63	64	63.8	63.7	63.7	64.3	64.9	64.2
Euro area	60.4	61.4	62.1	62.3	62.6	63.1	63.7	64.6	65.6	66	64.7
Luxembourg	61.7	62.7	63.1	63.4	62.2	62.5	63.6	63.6	64.2	63.4	65.2
Portugal	67.4	68.4	69	68.8	68.1	67.8	67.5	67.9	67.8	68.2	66.3
Slovenia	62.2	62.8	63.8	63.4	62.6	65.3	66	66.6	67.8	68.6	67.5
Finland	66.4	67.2	68.1	68.1	67.7	67.6	68.4	69.3	70.3	71.1	68.7
Cyprus		65.7	67.8	68.6	69.2	68.9	68.5	69.6	71	70.9	69.9
Germany	65.2	65.6	65.8	65.4	65	65	66	67.5	69.4	70.7	70.9
Austria	68.6	68.5	68.5	68.7	68.9	67.8	68.6	70.2	71.4	72.1	71.6
Netherlands	71.7	72.9	74.1	74.4	73.6	73.1	73.2	74.3	76	77.2	77

Source: Eurostat

Table 3: Gini Coefficient

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Slovenia	:	22	22	22	22	:	24	24	23	23
Slovakia	:	:	:	:	:	:	26	28	24	24
Austria	26	24	24	:	27	26	26	25	26	26
Finland	24	24	27	26	26	25	26	26	26	26
Malta	:	30	:	:	:	:	27	27	26	27
Belgium	29	30	28	:	28	26	28	28	26	28
France	29	28	27	27	27	28	28	27	26	28
Cyprus	:	:	:	:	27	:	29	29	30	28
Luxembourg	27	26	27	:	28	26	26	28	27	28
Netherlands	26	29	27	27	27	:	27	26	28	28
Euro area	:	:	:	:	:	:	29	29	30	30
Germany	25	25	25	:	:	:	26	27	30	30
Ireland	32	30	29	:	31	32	32	32	31	30
Spain	33	32	33	31	31	31	32	31	31	31
Italy	30	29	29	:	:	33	33	32	32	31
Greece	34	33	33	:	35	33	33	34	34	33
Portugal	36	36	37	:	:	38	38	38	37	36

Source: Eurostat

Table 4: Social Protection Expenditures (PPS per inhabitant)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Slovakia	1815.3	1855.6	1963.8	2112.9	2088.4	2124.5	2234.9	2451.0	2675.1
Malta	2626.0	2715.4	2739.1	2904.0	2979.8	3121.7	3241.9	3305.4	3500.9
Cyprus	:	2500.3	2685.4	2976.6	3387.0	3537.5	3760.0	3917.8	4175.9
Portugal	2979.5	3230.4	3478.0	3730.8	3821.9	3989.0	4384.9	4574.8	4700.6
Slovenia	3460.3	3685.3	3861.8	4111.0	4104.0	4367.8	4526.6	4703.3	4760.5
Spain	3393.2	3761.6	3881.8	4188.1	4316.9	4522.0	4803.2	5138.7	5526.4
Greece	3352.9	3759.9	4160.1	4429.4	4505.6	4792.7	5067.8	5387.0	5719.9
Italy	5195.4	5501.6	5813.4	5798.7	5922.7	6002.2	6218.0	6539.4	6773.3
Ireland	3273.9	3467.8	3893.5	4931.4	5217.5	5569.8	5865.0	6350.9	7054.4
Euro area	:	5721.8	5949.0	6243.7	6367.0	6560.3	6827.2	7059.0	7311.9
Finland	5381.1	5597.7	5700.3	6047.1	6213.0	6708.4	6866.3	7117.7	7321.2
Germany	6363.5	6616.4	6791.9	7093.0	7354.3	7503.3	7804.0	7858.7	7943.1
France	6111.6	6473.0	6768.1	7204.7	7158.1	7448.5	7798.1	7918.1	8264.3
Austria	6771.7	7110.8	7125.2	7540.9	7785.4	8048.2	8092.9	8350.9	8640.2
Belgium	5917.6	6358.6	6667.7	7173.1	7420.3	7667.3	7966.6	8446.1	8657.6
Netherlands	6311.3	6746.5	7005.3	7527.2	7575.7	7926.2	8191.5	8912.3	9293.2
Luxembourg	8692.4	9139.9	9667.2	10614.1	11361.8	12200.5	12413.0	12900.0	13231.3

Source: Eurostat

Table 5: Social Protection Expenditures (% of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Slovakia	20.2	19.4	19.0	19.1	18.2	17.2	16.5	16.3	16.0
Malta	17.8	16.9	17.8	17.8	18.3	18.8	18.6	18.2	18.1
Cyprus	:	14.8	14.9	16.3	18.4	18.1	18.4	18.4	18.5
Portugal	21.4	21.7	22.7	23.7	24.1	24.7	25.3	25.4	24.8
Slovenia	24.1	24.2	24.5	24.4	23.7	23.4	23.0	22.7	21.4
Spain	19.8	20.3	20.0	20.4	20.6	20.7	20.9	20.9	21.0
Greece	22.7	23.5	24.3	24.0	23.5	23.5	24.6	24.5	24.4
Italy	24.8	24.7	24.9	25.3	25.8	26.0	26.4	26.6	26.7
Ireland	14.6	13.9	14.9	17.5	17.9	18.1	18.2	18.3	18.9
Euro area	:	26.7	26.8	27.4	27.8	27.7	27.7	27.4	27.0
Finland	26.3	25.1	24.9	25.7	26.6	26.7	26.8	26.2	25.4
Germany	29.2	29.3	29.4	30.1	30.4	29.8	29.7	28.7	27.7
France	29.9	29.5	29.6	30.4	30.9	31.3	31.4	30.7	30.5
Austria	29.0	28.4	28.8	29.2	29.6	29.3	28.9	28.5	28.0
Belgium	27.0	26.5	27.3	28.0	29.0	29.2	29.6	30.2	29.5
Netherlands	27.1	26.4	26.5	27.6	28.3	28.3	27.9	28.8	28.4
Luxembourg	20.5	19.6	20.9	21.6	22.1	22.3	21.7	20.3	19.3

Source: Eurostat

Table 6: Value added at factor cost by sector of activity in 2006 - NACE divisions (millions of euro)

	Mining and quarrying	*Manufacturing*	*Electricity, gas and water supply*	*Construction*	*Hotels and restaurants*	*Real estate*	*Transport, storage and communication*	*Wholesale and retail trade*
Belgium	345	50682	5723	11081	3723	30953	18639	32475
Germany	6473	459393	44232	55442	23225	242112	118704	202961
Ireland	1167	35498	2074	9220	3407	16031	7130	16384
Greece	951	15825	2682	6384	3457	8776	9208	22268
Spain	2500	132370	15131	94262	25172	102464	58679	106230
France	4612	215482	25777	69552	28529	202551	97268	151491
Italy	7323	218775	19792	63258	21993	108067	76092	116044
Cyprus	43	1135	283	1207	919	1200	1035	1735
Luxembourg	33	2756	269	1620	492	4077	2573	2599
Netherlands	6514	60128	5890	23916	6610	65342	33013	58531
Austria	936	44701	5896	12229	6390	25697	15279	26519
Portugal	678	18773	3405	8594	3072	11279	9426	16170
Slovenia	122	6433	643	1419	462	1919	1706	3055
Slovakia	187	6940	2674	989	174	1987	1912	3188
Finland	415	33226	3317	7008	1806	13806	9422	13468

Source: Eurostat

Table 7: Number of employees by sector of activity in 2006 - NACE divisions

	Mining and quarrying	*Manufacturing*	*Electricity, gas and water supply*	*Construction*	*Hotels and restaurants*	*Real estate*	*Transport, storage and communication*	*Wholesale and retail trade*
Belgium	3174	572844	22671	197130	121262	425144	219665	468514
Germany	86128	6933924	276177	1318689	1102657	3811231	1850700	4295276
Ireland	6174	218110	8980	71420	135586	186355	85768	294323
Greece	12876	305482	24318	193067	155911	193987	142041	545913
Spain	37352	2451390	64619	2384513	970448	2211620	849190	2640575
France	32805	3577366	194901	1471855	828397	3154272	1499091	3112741
Italy	37664	3834094	111523	1127103	702753	1584261	1034372	1827039
Cyprus	537	34096	1760	30847	31508	18856	20836	55506
Luxembourg	321	36590	1057	34705	13441	48496	23984	39888
Netherlands	7405	735825	24081	375762	301544	1474867	446060	1222616
Austria	5806	602443	30746	233507	194557	347821	228533	548476
Portugal	13549	809961	23418	466873	256506	567585	190181	826833
Slovenia	3718	225016	11470	60555	27015	60524	48917	100998
Slovakia	8838	410971	38760	71688	21584	108341	102888	188515
Finland	3416	400143	16024	122947	49492	207927	144984	248048

Source: Eurostat

Table 8: External Balance of Goods and Services (% of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Greece		-13.5	-13.2	-13.5	-12.3	-9.8	-9.2	-10.6	-11.1	-10.2	-9.7
Portugal	-10.2	-10.9	-10.0	-8.3	-6.6	-7.8	-8.9	-8.2	-7.5	-9.6	-7.6
Spain	-1.9	-3.1	-2.5	-2.1	-2.4	-4.0	-5.3	-6.4	-6.8	-5.9	-2.1
Slovakia	-4.4	-2.5	-8.0	-7.2	-1.8	-2.7	-4.6	-4.0	-1.0	-2.3	-0.2
Malta	-5.3	-10.7	-4.7	2.4	-1.7	-3.9	-5.4	-5.0	-2.0	-3.0	2.6
Cyprus	1.7	0.8	2.1	-1.6	-1.2	-2.5	-2.6	-3.8	-6.3	-11.5	-5.8
Slovenia	-4.2	-3.5	-0.8	1.2	-0.2	-1.3	-0.4	-0.5	-1.7	-3.0	1.5
France	2.1	0.9	1.1	1.7	1.0	0.1	-0.9	-1.3	-1.9	-2.2	-1.9
Italy	1.9	0.9	1.4	1.0	0.6	0.7	-0.1	-0.8	-0.2	-0.6	-0.4
Euro area	1.6	1.0	1.5	2.6	2.0	2.1	1.5	1.2	1.6	1.1	1.4
Belgium	4.2	2.9	3.6	5.7	5.4	4.9	3.9	3.7	3.9	0.9	2.8
Austria	1.2	1.8	2.2	4.8	3.5	3.8	4.0	4.8	5.9	5.8	4.2
Germany	0.9	0.4	2.0	4.6	4.0	5.1	5.3	5.7	7.1	6.2	4.7
Finland	9.1	9.1	9.4	9.2	6.8	6.5	4.1	4.7	5.2	4.0	2.8
Netherlands	4.2	5.5	5.8	6.5	6.3	7.4	8.5	7.7	8.6	8.3	7.2
Ireland	13.9	13.5	15.6	17.2	16.1	15.0	11.9	9.9	10.2	10.4	17.2
Luxembourg	19.3	21.0	17.6	19.6	23.7	24.2	25.5	31.4	33.5	32.5	33.6

Source: Eurostat

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Friends of Europe – Les Amis de l'Europe
Bibliothèque Solvay
137 rue Belliard, B-1040 Brussels, Belgium
Tel.: +32 (0) 2 737 9145 – Fax: +32 (0) 2 738 7597
www.friendsofeurope.org