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## Abstract

The EMU governance has showed to be incapable of an effective crisis management following the global downturn. The recent decisions by European Council taken in March 2011, named the 'Pact of the Euro', to design a new governance of the EMU can be considered a significant attempt to give new and effective national budgetary rules, crisis management and resolution principles and procedures, economic policy framework to the Member States of the euro area, although several questions remain open.

The present work seeks to investigate the causes of the crisis of the euro area and review the debate about the future of the EMU. Moreover this contribution evaluates critically the new governance of the EMU and the economic policy framework established by the Pact of the Euro underlying the need of adequate institutions, greater cooperative attitude and political coherence.

Keywords: EMU, Global crisis, European integration, Pact of the Euro
JEL Classification: F15, F33, F36, O52

## Introduction

The European Monetary Union (EMU) and the creation of the euro, its common currency, have been an important economic and political achievement. Yet, the EMU governance has showed to be incapable of an effective crisis management, whereas the institutions have proved to be hesitant and without a real political leadership. In the meantime Europe has become a low growth macro-region in decline with respect to the rising powers of China, India and other emerging countries.

The recent decisions by European Council taken in March 2011, named the 'Pact of the Euro', to design a new governance of the EMU can be considered a significant attempt to give new and effective national budgetary rules, crisis management and resolution principles and procedures, economic policy framework to the Member States of the euro area, although several questions remain open.

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## 1. The crisis in the euro area and its causes.

The Maastricht Treaty of 1992 stipulated that the future governance of the EMU was based on a monetary union without a significant federal budget, on a limited coordination of budgetary and structural policies, with no form of integrated financial supervision, with no political authority to counterbalance the (future) European Central Bank (ECB). Because of this asymmetry in the governance, the Treaty introduced some safeguards: i) the no-bailout clause, which established that national governments alone were in charge of their budget and that no European government or official institution was allowed to rescue another eurozone member in case of public debt difficulties[1]; ii) the ECB was barred from financing public debts. All this was considered by many of its writers as a temporary situation that would develop later[2].

So in 1999 the EMU began with the launch of the euro. In 1997 the adoption of the Stability and Growth Pact (SGP) should have guaranteed that fiscal discipline would be maintained and enforced in the EMU[3]. Consequently, Member States adopting the euro have to meet the Maastricht convergence criteria, the SGP should ensure that eurozone countries will continue to observe them.

Coordination of national fiscal policy was facilitated by the Eurogroup (Eurozone Financial Ministers), which emerged as a forum for informal coordination. Therefore the budget policy in each country of the eurozone should have been under

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[1] The clause really espressed a 'no-coresponsibility' principle for public debts (Art.125 of the Treaty). Even if any euro area country could request assistance from IMF.
[2] Although Eichengreen and von Hagen (1996) made clear that a monetary union without a fiscal union was incomplete.
[3] SGP aimed at keeeping deficits below 3% of GDP in normal times and debt levels below, or at leats heading towards, 60% of GDP.

control, although in practice this has not happened, because of the lack of an effective mechanism of enforcement in the Pact[4]. Banking and financial market regulations were also left to national governments, with only loose coordination, because of the assumption that financial markets “would work well”. Finally, competitiveness policy was almost overlooked in the institutional design of the EMU.

Despite some underlying weaknesses that have characterized the euro since its inception, the results of EMU governance were pretty good. In fact, the EMU has been relatively successful for almost ten years, by keeping the macroeconomic stability of the entire euro area with inflation rates close to the target of the ECB and with fiscal policies of EMU countries which did not differ significantly from the objective of the SGP. The adoption of the euro has also facilitated structural reforms in the product markets[5]. Over the decade the euro area has enjoyed an high per capita income and a substantial balance of the eurozone’s overall trade account. Furthermore, the euro has become an important currency in the global monetary system, but without replacing the dollar as the currency of reference of the whole system; in fact, it carved a significant place over the borders of the euro area in the strict sense, becoming the second international reserve currency after the dollar at the global level[6].

With the outbreak of the global crisis of 2008-2009, probably the worst in the world economy since the 1930s, many countries of the euro area have relied on state spending

[4] Paradoxically, France and Germany were the first two countries that have not respected the SGP, as in 2003-04 they have been lobbying to change the original SGP, to make it ‘more flexible’.

[5] Alesina, Ardagna, Galasso (2010) who underlined that the same did not happend in the labour market.

[6] Pisani-Ferry, Posen (2009).

to drive growth, so they have recorded high deficit/GDP ratio and rising public debt.

Table 1 describes the deficit and the debt as percentage of GDP for the 16 euro countries in 2009.[7]

**Table 1.**

| | **Deficit/GDP (2009)** (percentage values) | **Debt/GDP (2009)** (percentage values) |
|---|---|---|
| **Austria** | **3.4** | **66.5** |
| **Belgium** | **6.0** | **96.7** |
| **Cyprus** | **6.1** | **56.2** |
| **Finland** | **2.2** | **44.0** |
| **France** | **7.5** | **77.6** |
| **Germany** | **3.3** | **73.2** |
| **Greece** | **13.6** | **115.1** |
| **Ireland** | **14.3** | **64.0** |
| **Italy** | **5.3** | **115.8** |
| **Luxemburg** | **0.7** | **14.5** |
| **Malta** | **3.8** | **69.1** |
| **Netherlands** | **5.3** | **60.9** |
| **Portugal** | **9.4** | **76.8** |
| **Slovakia** | **6.8** | **35.7** |
| **Slovenia** | **5.5** | **35.9** |
| **Spain** | **11.2** | **53.1** |
| ***Euro Area*** | ***6.3*** | ***78.7*** |

***Source: Eurostat***

[7] Since January 2011 Estonia joined the euro, so that the euro area members have now become 17.

The Table shows that nearly all the countries of Eurozone accumulated large deficit/GDP ratio in 2009. The average value of Deficit/GDP ratio for the whole eurozone was 6.3%. While the average growth rate of real GDP for the 16 member countries was, in the period 2001-2009, 1.08%; in particular it was 0.6% in 2008 and – 4.1% in 2009. This means that eurozone's GDP has been growing much less than budget defict and public debt. Moreover, most of the countries have also increased their debt, in fact only six countries out of sixteen had debt/GDP ratio less than 60% in 2009[8]. All this has created deep concerns about the fiscal sustainability and the credibility of whole eurozone. However, the euro area countries most affected by the crisis: Greece, Ireland, Portugal and Spain – the "GIPS"– have spent and lived beyond their means by accumulating private and/or public debt and running large current account deficits. Particularly Greece has accumulated a huge sovereign debt of about 310 billion euros, mainly due to public finance mismanagement, so that its financial esposition prevented the Greeek government to find capital in the financial markets, therefore Greece became at risk of sovereign default. But also Ireland was in a risky position because of the large private debt due to the mismanagement of its banks.

The behaviour of all these countries of course was at odds with euro participation and raised the issue of the future existence of the euro. So the vision about the governance of EMU and its principles changed significantly and a debate on the future of the euro was opened, while the crisis cleraly showed the lack of coherence of European politics.

[8] Really, from 1980 to 2007 nearly all the OECD governments increased their indebtedness ratio, this happened because short-term economic needs and electoral interestes prevailed over the long-term sustanaibility issues.

## 3.The debate on the euro area crisis.

The crisis inevitably opened a debate on the political and economic governance of the EMU, which has been criticized mainly because of the lack of crisis management and resolution regime, the incompleteness of the economic policy framework, the unclear role of the European institutions.

Barry Eichengreen has correctly underlined the need for Europe to build out the institutions of its monetary union to be able to avoid similar crises in the future[9].

Transparency is called by Burda and Gerlach[10], who suggest a new SGP that significantly increases fiscal transparency through a creation of an independent committee of fiscal experts (a "Fiscal Stability Board") able to evaluate objectively the national budgets and to impose sanctions on the countries that do not keep their fiscal house in order. Fatás and Mihov[11] also agree on the crucial role of an independent institution (i.e. a fiscal policy council) to monitor and enforce the national fiscal policy. These authors propose a sort of "constrained discretion" on national budgetary policy with the aim of ensuring sensible policy in the long run.

The fiscal policy failure is certainly an important cause which was necessary to trigger the crisis in Greece, but it was not sufficient *per se* to create panic throughout the euro area, if the banks were strong enough and not interconnected with the sovereign debt[12]. So many scholars argued that the main causes of the crisis have been the increasing debt and the serious difficulties of the banking system, that are inevitably

[9] Eichengreen (2009).
[10] Burda, Gerlach in Baldwin et al. (2010, pp.65-68).
[11] Fatás, Mihov in Baldwin et al. (2010, pp.69-72).
[12] Banks of the euro area are largely exposed to the peripheral countries.

intertwined, where the interconnectedness aspect is the crucial one.

Another important point is that the crisis has exposed flaws in the peer review process which put disproportionate emphasis on fiscal discipline, while no one was paying attention to excessive home consumption and to the current account deficits, due to the false convergence between bond yields post EMU launch, which left the "GIPS" countries borrowing at rates little higher than Germany, leading to large speculative inflows, higher wages and a loss of competitiveness.

But a major cause why the global financial crisis struck the euro area severely was that it coincided with a period of weak political leadership which has made crisis management even harder.

According to Pisani Ferry (2010), since the governance of the EMU has been incomplete and ineffective, it necessary to reformulate the economic policy framework considering also the problems of competitiveness, of trade imbalances and of low and uneven growth inside the eurozone[13]. He is also favorable to governance reforms that encourage decentralisation by rewarding countries with better institutions or rules[14].

We share the view that if the eurozone economy wants to survive in the medium-long term, it will be necessary that its institutions must provide an effective crisis resolution system, a better fiscal policy co-ordination, which should take in perspective towards a fiscal union, coopetitive policies to

[13] Moreover, a policy regime is complete if it provides for how to behave in different conditions (in good times and in times of bad times). [13] Pisani-Ferry and Sapir (in Pisani-Ferry, Posen 2009, p.71) already argued that the qualities that are expected from a policy system in cisis times are clearly different from those expected from the same system in normal times.

[14] Pisani-Ferry (2010, p.7): "decentralisation may be the best way to strengthen the ownership of policy rules".

reduce intra-eurozone imbalances. Furthermore, the euro area should have a single European bond.

## 4. The new governance of the EMU

In the last two years policy measures have been taken by the EU institutions and by the single countries, except for some hesitation, to start the adjustment process. In May 2010 a program of financial aids supported by the eurozone countries and by IMF to help Greece was provided because the country was on the verge of insolvency[15]. Another important measure was the ECB's "secutities market programme" by which ECB buys government debt of fiscally "challenged" countries[16]. The ECB's decision helped the member countries most affected by the crisis – the "GIPS" – to finance their 2010 budget deficits. Then it was decided to implement the European Financial Stability Facility (EFSF), that will run out in 2013, which gives credits to countries in financial troubles[17].

The European Commission, following the crisis, stated that there are two other important objectives of economic policy in addition to the price stabilty and fiscal discipline: one is financial stability, which has become evident and necessary

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[15] However, the crisis of Greece, despite the EU-IMF bailout financial program and the severe austerity measures taken by the Greek government, is still far to be solved.

[16] To sterilize this move the ECB conducts liquidity absorbing operations of the same magnitude. Effectively, the ECB is buying risky assets issued by a fiscally troubled governement of the eurozone and, via its sterilization operations, selling its claims on banks, which is equivalent of selling new assets. A move that might be viewed as an improper risk transfer.

[17] EFSF bases its rules of the crisis management regime on the principles and procedures of the "IMF doctrine". The EFSF operates in the case of unstainable fiscal policies and sovereign debt crises.

after the crisis, the other is the avoidance of – or at least to contain – macroeconomic imbalances.

The identification of two new targets raises the question of the definition of the instruments, which requires better coordination of economic policies among member countires.

In a paper by Carfì and Schilirò (2010), we suggested that the macroeconomic imbalances, such as trade imbalances, can be addressed through a coopetitive strategy, which implies a cooperative attitude among the national governments of the euro area, despite their divergent interests. The coopetitive strategy will provide a *win-win solution* to the actors of the game and can constitute a new macroeconomic policy tool to help solving the imbalances problems and contribute to overcome the economic crisis in a medium-run perspective.

The EMU governance, established in the Maastricht Treaty, had a no bail-out clause to limit the cooperative attitude among the member countries of the EMU; this choice was made to underline the individual responsibily of the governments and to emphasize the strong faith in the market capacity to overcome any difficulties. But this clause revealed itself too rigid and irrealistic in crisis time. The new rules of the EMU governance cointained in the "Pact of the Euro" have transformed the old no-bailout clause in another irrealistic rule concerning the crisis resolution. The eurozone leaders committed to increasing the lending capacity of the current rescue fund, the EFSF[18], making it able to bail out several eurozone countries should the debt crisis continue to spread[19]. They also established the creation of a permanent post-2013 fund − the European Stability Mechanism (ESM) – that will be able to lend up to

[18] From about €250bn to its full, headline level of €440bn.

[19] Greece and Ireland were the two troubled eurozone countries that asked the European Union for emergency support to ensure that they could continue to finance their debt. Portugal has become the third in April 2011.

€500bn, likely to be achieved through guarantees from triple-A states. In the face of German and Dutch resistance, the leaders chose to set some limits. The fund will be able to buy bonds, but only directly from a struggling government and only after that government agrees to austerity measures. However these new financial facilities can only be used in a narrow set of circumstances[20], which limit their application and convenience for the struggling countries.

The agreement reached by eurozone's leaders was a smart politically compromise. Unfortunately, compromise could not work in a debt crisis. There are, in essence, two ways to solve a debt crisis: through a bail-out or through default. The leaders of the euro area got itself an arrangement that represents only an emergency facility and constitutes a scarsely credible intermediate solution between bail-out and default.

To understand this agreement, it is important to focus on some technical aspects of the financial rescue mechanisms. The current EFSF will run out in 2013. It gives credits to countries in trouble, and may soon buy their bonds on the primary markets. These rank on the same terms with everybody else's investments. That means, should the country default, everybody gets hit equally. If, say Greece, were to default today, Germany and France would have to keep their credit guarantees to the EFSF, but this would be a political disaster. The creditor nations would therefore not allow a default until 2013. In 2013, the new ESM will replace the EFSF. The crucial difference between the two is that its credits will be senior to those of private investors. The idea is to make default possible, with only a moderate risk to the budget of the creditor nations. By 2013, the European banks should be in a better position

[20] The fund will provide assistance only as a last resort, by unanimity and with harsh conditionality,

than today to absorb big losses, or so one hopes, therefore there could be the end of crisis. But unfortunately financial markets do not follow such ideas. What has been happening is that forward-looking investors see through this scheme, and correctly assess the risk of a future default, also for existing bonds. They know that once a country defaults, old and new bonds will be treated alike. Policymakers in Germany or France are just as unlikely to push for a managed default in 2013 as they are now. In 2013 the crisis will not be ended, so they will make another loan with high interest rates, and demand another austerity plan – one that stands as little chance of success as the present ones. This game will continue until the debtor country's economy collapses under its debt burden, at which point the inevitable default will be very unpleasant[21].

All debt crises are politically difficult to solve because they involve making choices about who will ultimately bear the burden of the accumulated debt, between the borrowers, the lenders and the taxpayers. The comprehensive solution to the euro area crisis cannot avoid some difficult, but inevitable and transparent, political choices. A reasonable and coherent solution would be for instance to accept the principle of a bail-out, not through cross-country transfers, but by means of a single European bond that replaces all national debt[22].

The Pact of the Euro includes important commitments to prevent crisis that regard legislative measures to strengthen eurozone budget rules. The new regime will take into account the debt ratio and implicit liabilities[23]. The Pact, moreover, made it harder for politicians to veto fines

[21] Probably the current policymakers may be no longer in office by then and can blame therefore their successors for the mess.

[22] The idea of Eurobonds is strongly supported by Quadrio Curzio (2010).

[23] So that a country with an oversized banking sector will have to factor in potential rescue costs

imposed on recalcitrant debtors. Another positive aspect is the

recognition that not all crises are rooted in a lack of budgetary discipline. It is now agreed that financial stability and macroeconomic stability also matter. The Pact also commits the euro partners to closer economic co-ordination and to a series of new austerity measures, including close monitoring of pension schemes, and limits on public sector wage increases. As it stands, however, the Pact remains an agreement on principles without enforcement[24].

But some problems remain unsoved. There is an urgent need to expedite the resolution of the banking crisis. Moreover, an equally important need is to sort out state insolvency cases from illiquidity cases (Greece is likely to find itself insolvent and there are questions about Ireland and Portugal). The issue of exit strategy for the ECB that needs to know how it will get rid of the peripheral bonds on its balance sheet. The question of how the eurozone periphery will achieve debt sustainability, since there is still no serious answer to the problem of sustainability of public debt. Finally, the eurozone needs a strategy to revive growth particularly in southern Europe.

**Conclusions.**

The new governance of the EMU has given a response to the crisis which certainly made important corrections to the original weaknesses. However, several issues remain open. This contribution has underlined the need of a greater

[24] Germany and the President of ECB, Trichet, backed a version that included the possibility of sanctions for violators.

cooperation among the member countries to implement the economic policies, a coopetitive strategy to face macroeconomic imbalances, a more effective fiscal policy regime. The need for a clearer solution of the debt crisis. But it is crucial the good health of the banking system, the sustainability of the debt burden of the peripheral countries and a medium term strategy for growth based on reforms that would help the eurozone economies grow out of increased public debt.

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