A new governance for the EMU and the economic policy framework

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April 2011

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July 2011

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Abstract

The severe crisis that affected the European Monetary Union has emphasized the prevailing interests of national governments and a lack of political leadership of the European institutions, while the governance of the euro area has been incapable of an effective crisis management.

The present work argues that the decisions taken in March 2011 by the European Council, named the 'Pact for the Euro', to design a new governance of the EMU, can be considered a fairly significant step for the European institutions in terms of credibility and legitimacy. This contribution, evaluating the economic policy framework set by the Pact for the Euro, underlines the need for appropriate institutions and a stronger attitude to cooperate among the Member States. It also stresses the need for transparency and a non ambiguous solution of the debt crisis. The major message of this work is that Economic and Monetary Union must equip itself with appropriate policy tools to manage and resolve the crisis, creating the condition to improve the competitiveness of the peripheral countries of the euro area and fostering growth. But, at the same time, Member States of the euro area and European institutions must demonstrate greater accountability and political coherence.

keywords: EMU, European integration, crisis management, Pact for the euro
Jel classification: F15, F33, F36, O52.

Introduction°

The severe crisis that affected the European Monetary Union (EMU) has showed the European institutions to be hesitant and without a real political leardership, emphasizing, at the same time, the prevailing interests of national governments, while the governance of the euro area has been incapable of an effective crisis management.

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

The present contribution examines the debate and the proposals regarding the governance of the EMU. In addition, the work, critically evaluating the economic policy framework set by the Pact for the Euro, underlines the need for appropriate institutions and a stronger attitude to cooperate among the Member States. The major message of this work is that Economic and Monetary Union must equip itself with appropriate policy tools to manage and resolve the crisis, whereas Member States of the euro area and European institutions must demonstrate greater accountability and political coherence.

° Revised version of the paper presented at the International Workshop on 'Legitimacy and Efficiency in Global Economic Governance' 06th – 07th May 2011 – Lecce.

I wish to thank Susanna Cafaro and David Carfì for the helpful discussions and suggestions. The usual disclaimer applies.

1. The euro area governance and the global crisis.

The European Monetary Union is an incomplete system, as Eichengreen and von Hagen (1996) made clear, since it is based on a monetary union without a fiscal union. This original Economic and Monetary Union has been designed in the following way. It has a common currency, the euro, but does not have a significant federal budget and a form of integrated financial supervision. The fiscal discipline of the Member States is based on the Stability and Growth Pact (SGP), which in practice lacks of an effective mechanism of enforcement[1]. Coordination of national fiscal policy is facilitated by the Eurogroup (Eurozone Financial Ministers), which has emerged as a forum for informal coordination. The system has been conceived with two safeguard clauses: i) the no-bailout clause, which establish that national governments alone are in charge of their budget and that no European government or official institution is allowed to rescue another eurozone member in case of public debt difficulties[2]; ii) the ECB is barred from financing public debts.

Banking and financial market regulations are left to national governments, with only loose coordination, due to the assumption that financial markets "would work well". The competitiveness policy has been almost overlooked in the institutional design of EMU.

Despite the underlying weaknesses that have characterized the euro since its inception, the results of EMU governance

[1] 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'. Thus in March 2005 the European Council has reformed the SGP in order to improve the implementation of the Pact in accordance with the Lisbon strategy and, therefore, to enlarge its targets.

[2] 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.

have been quite satisfactory until the emergence of the global crisis. The inflation rates of the entire euro area have been close to the target of the ECB. The adoption of the euro has also facilitated structural reforms in the product markets[3]. Over the decade the euro area has enjoyed an high per capita income and a substantial balance of the eurozone's overall trade account[4]. 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 has 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 (Pisani-Ferry, Posen, 2009).

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 to drive growth, so they have recorded high deficit/GDP ratio and rising public debt. The average value of deficit/GDP ratio for the whole eurozone was 6.8% in 2009. 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[5]. But the debt situation has worsened in the euro area in 2010 (Eurostat, 2011). The euro area's GDP instead has been growing much less than budget defict and public debt. All this has created deep concerns about the fiscal sustainability and the credibility of European Economic and Monetary Union. In particular, the member countries most affected by the crisis:

[3] Alesina, Ardagna, Galasso (2010) have highlighted this issue, but they stressed that the same has not happened in the labour market.

[4] Actually, there have been growing current account imbalances between the countries of North and South of the euro area over time (Holinski et al. 2010).

[5] 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.

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. Thus international capital markets reacted by demanding risk premiums for continuing holding public debt of GIPS.

The behavior of all these countries of course has been at odds with euro participation and has raised the issue of the future existence of the euro. As the result of that, the vision about the governance of EMU and its principles have changed significantly, then a debate has been opened on the future of the euro, while the crisis has clearly shown the ambiguity of the institutional architecture and the lack of coherence of European politics.

2. The decisions of EU institutions after the crisis.

After the crisis, th institutions of the European Union and individual member countries have taken a number of economic policy measures to start the process of adjustment and try to solve the difficult economic and financial situation. In spring 2010, the EU together with the IMF have decided a program of financial aids to help Greece since the country was on the verge of insolvency. To overcome the no bail-out clause the European Council approved the financial aids in the form of "coordinated bilateral loans" at a non-discounted interest rates[6]. Another important measure was the ECB's "securities market programme" by which ECB decided to buy government debt of fiscally "challenged" countries[7]. Subsequently, also the

[6] In April 2010 Greece requested the payment of the "loans", that was to be approved unanimously by the European Council. But the interest rate of the loans by the Members States was 5%, lower than the 7% demanded by the markets.

[7] 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

member banks of the European System of Central Banks started buying government debt. This measure aimed at reducing volatility in the financial markets and at improving liquidity. In practice, the ECB's decision helped the member countries most affected by the crisis – the "GIPS" – to finance their 2010 budget deficits.

On 9 May 2010, the 27 Member States of European Union agreed to create a comprehensive rescue package, a legal instrument aimed at ensuring financial stability in Europe, so the European Financial Stability Facility (EFSF) was started to give credits to countries in financial troubles[8]. The ESFF is devised in the form of a special purpose vehicle (SPV) that will sell bonds and use the money it raises to make loans to eurozone nations in need. The bonds will be backed by guarantees given by the European Commission representing the whole EU, the eurozone member states, and the IMF. The EFSF will sell debt only after an aid request is made by a country. The EFSF will run out in 2013.

3.The debate and the proposals 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.

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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.

[8] EFSF has become operative in August 2010. It bases its rules of the crisis management regime on the principles and procedures of the "IMF doctrine". The EFSF operates in case of unstainable fiscal policies and sovereign debt crises. Thus the Greek bail-out was followed by a €85 billion rescue package for Ireland in November 2010.

Barry Eichengreen (2009) 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. After all, the Treaty of Lisbon of 2007 has left unchanged the economic governance, which has remained incomplete and weak, as demonstrated by the gap between the economic policy based on cooperation between the Member States, in which the autonomy of national governments has been maintained, and a monetary policy common to all States adopting the euro.

It is possible to cite some examples of inadequacy of the institutional architecture. First, the relationship between the Member States of the euro area and the EU institutions (in particular the Commission, but also the European Parliament) is unclearly defined, because of the strong interests of the Member States. Thus, national interests still prevail over the interest of Europe and within the European institutions. Second, the European Union decides a growing number of policies without having a policy at European level, while at national level it has a policy without being able to decide on policies to implement it. This mismatch creates an unstable environment and a variety of problems. The effects of this mismatch are clear in the euro crisis. Third, it looks awkward the position of the ten Member States of non-euro area, who sit in the European Council but do not express themselves on the issues concerning the euro area. Although such decisions influence as well the non euro area members. There is, therefore, a problem of transparency and legitimacy in the decision process at institutional level.

Fiscal policy is another controversial point. The original sin of fiscal policy in the euro area is the weakness of its framework of coordination between the Member States. The SGP lacks of binding rules that make its enforcement effective; moreover the system revealed scarce transparency. However, there is a general agreement on the goal to maintain budget discipline in each country in the medium and long term (fiscal sustainability), but with enough flexibility to handle cyclical adjustments in the short term.

There are some specific proposals on fiscal policy like that of Burda and Gerlach[9], who suggest a new SGP that significantly increases fiscal transparency through a creation of an independent committee of fiscal experts (a "Fiscal Stability Board"). Fatás and Mihov[10] also agree on the crucial role of an independent institution (i.e. a fiscal policy council) to monitor and enforce the national fiscal policy. Weber (2010), instead, is against any discretionaty decison concerning the sanctions. He suggests to install a system of automatic sanctions. In addition, Weber argues that it is not sufficient to focus on the budget deficit alone, as was done in the past; it is also necessary to place more emphasis on the level of national debt.

Another important issue is the role of the banking system. The crisis in the euro area could be less severe, if the banks had been strong enough and not interconnected with the sovereign debt[11]. Thus many scholars have argued that the main causes of the crisis have been the increasing debt and the serious difficulties of the banking system, that are inevitably intertwined. The fragility of banks and its interconnectedness with the debt crisis created a severe macroeconomic problem. During the crisis the governance of the euro area revealed the lack of a coordinated banking policy, which, on the opposite, is crucial for the crisis management. Moreover, «banking policy failed to provide capital cushions large enough to absorb a GIPS debt crisis without putting the core nations' banking

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[9] Burda, Gerlach in Baldwin et al. (2010, pp.65-68).

[10] Fatás, Mihov in Baldwin et al. (2010, pp.69-72).

[11] Banks of the North countries of euro area (especially France and Germany) are largely exposed to the peripheral countries.

systems at risk» (Baldwin and Gros in Baldwin et al. 2010, p.16). Thus an important economic policy target to avoid crises is to maintain stability of banking system.

An additional relevant point is that the crisis has exposed flaws in the peer review process, which put disproportionate emphasis on fiscal discipline. At the same time 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 reason why the global financial crisis struck the euro area severely was that it coincided with the lack of appropriate policy tools to manage the crisis and a period of weak political leadership which has made crisis management even harder.

From Bruegel, Pisani Ferry (2010) has argued that it is 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[12]. At the same time Gianviti et al. (2010) have supported the idea that the euro area needs a formal mechanism for dealing with sovereign-debt crises in an effective and predictable way. They start from the consideration the EU members have agreed to cooperate through supranational institutions within a common legal framework. Gianviti and his colleagues have proposed the creation of a European Crisis

[12] 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). 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.

Resolution Mechanism (ECRM),[13] established by a treaty, containing rules for the provision of financial assistance to euro area countries as an element in resolving the crisis, but also procedures between a sovereign debtor with unsustainable debt and its creditors to find an agreement on debt restructuring. The ECMR acknowledges the possibility of the default of a government on its debt; this possibility of default is a warning to creditors, so that they will differentiate among sovereign debt issuers.

Gros and Mayer (2010) made another proposal which is similar. They suggested the creation of a European Monetary Fund aimed at financing a mechanism for sovereign debt resolution. This European Moneraty Fund should represent the blueprint of an orderly sovereign default mechanism. It would contribute decisively to release the ECB from her role as a bad bank and to let the debtor countries and the creditors participate in the costs of sovereign default according to the costs-by cause principle (Belke, 2010).

Among the proposals for a new governance of the EMU, there is the idea of creating a common or centralized public debt instrument, establishing a single issuer of sovereign debt. A European government bond ('Eurobond') jountly issued by the euro area Member States, if is appropriately designed, could contribute to fiscal stability and offer significant advantages in terms of efficiency to the issuing governments of the euro area, but also to investors and financial intermediaries. As Favero and Missale (2010, p.91) maintened : "A common Eurobond is a strong form of debt management cooperation with the potential of promoting further market integration, greater liquidity and lower borrowing costs". There are may proposals on Eurobonds and it is possible to distinguish several

[13] Gros and Mayer (2010) made a similar proposal with the creation of a European Monetary Fund aimed at financing a mechanism for sovereign debt resolution.

types of Eurobond[14]. A recent porposal[15] to issue the Eurobond was conceived to restructure the public debts of the Member States of the euro area and also to reduce speculative attacks. In this way the Eurobond can contribute to the financial stability. This stability, in turn, would facilitate the creation of a deep and liquid market for European sovereign bonds, that would be able to compete with U.S. Treasury bonds[16]. In this proposal, these European government bonds should be issued by an European Debt Agency (EDA), which is also intended to substitute the European Financial Stability Facility (EFSF)[17].

The proposals concerning a European Monetary Fund and a common European bond can be regarded as very sensible and can be viewed with favor.

5. Towards a new governance of the EMU

The persistence of the crisis has pushed the euro area countries to take action. The European Council has therefore taken two relevant decisions in March 2011. The first is a new competitiveness pact, called "A Pact for the Euro", the second is the agreement regarding how to finance a permanent euro area rescue fund, the European Stability Mechanism (ESM). The agreement on the ESM, which implied a small Treaty change allowing for the use of the simplified treaty revision

[14] For a discussion on the different type of Eurobonds see Favero, Missale (2010).

[15] The proposal by Jean Claude Junker and Giulio Tremonti appeared in the *Financial Times* on December 5th 2010. Other proposals are made by Alberto Quadrio Curzio (2011), Lorenzo Bini Smaghi (2011).

[16] Quadrio Curzio (2011, p.283).

[17] EDA should buy bonds of Member States when they are issued, but also in the secondary market; in this way this agency replaces the market as a creditor. EDA, unlike normal investors, would not be asking a risk premium to the securities until maturity.

procedure[18], is part of a wider deal on measures to ensure the stability of the euro area and improve economic coordination.

The European Commision, already in 2010, 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 after the crisis, the other is the avoidance of – or at least to contain – macroeconomic imbalances. The recent measures, taken in March 2011, try to complete the economic policy framework in terms of objectives and instruments.

The Pact for the Euro, which has to do with economic governance *per se*, aims to achieve a better economic policy coordination leading to a higher degree of convergence. The Pact "focuses primarily on areas that fall under national competence and are key for increasing competitiveness and avoiding harmful imbalances" (European Council, 2011). The goals of the Pact for the Euro are: fostering competitiveness, fostering employment, contributing further to the sustainability of public finances, reinforcing financial stability.

In addition, the Pact includes important commitments to prevent crisis that regard legislative measures to strengthen euro area budget rules. The new regime will take into account the debt ratio and implicit liabilities[19]. The Pact also make it harder for politicians to veto fines imposed on recalcitrant debtors. A positive aspect included in this new economic policy framework is the recognition that not all crises are

[18] The simplified treaty revision procedure requires that all 27 EU countries agree.

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

rooted in a lack of budgetary discipline. It is now agreed that financial stability and macroeconomic stability also matter. The Pact for the Euro 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 for the Euro remains an agreement on principles without a real enforcement[20].

Since the Pact for the Euro focuses on competitiveness and envisages an EMU which does not become a transfer union, Carfì and Schilirò (2010, 2011) have suggested an approach based on coopetition. First, they have pointed out the primary role of competitiveness in determining growth and the relation between competitiveness and macroeconomic imbalances. Carfì and Schilirò have argued that to overcome macroeconomic imbalances it is necessary a medium term strategy for competitiveness and growth, based on innovative investments and a process of structural change of the production system. Within this broad strategy, trade imbalances, in particular, can be addressed through a coopetitive strategy, which implies a cooperative attitude aiming at growth among the member countries 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 measures concerning the crisis resolution, which encompass the creation of a permanent euro area rescue fund – the European Stability Mechanism (ESM) – contribute significantly to outline the new governance of the EMU.

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

First, the SGP was improved and hardened, but this new SGP does not dispose of any mechanism to override national sovereignity. Therefore it become a complement to goverment insolvency mechanism. Second, it is known that the no bail-out clause to limit the cooperative attitude among the member countries of the European Economic Monetary Union, established in the Maastricht Treaty, was made to stress the individual responsibility of the governments and to emphasize the strong faith in the market capacity to overcome any difficulties. This clause revealed itself too rigid and irrealistic in crisis time. Similarly, the new rules of the EMU governance have transformed the old no-bailout clause into another irrealistic rule concerning the crisis resolution. The leaders of the euro area committed themselves to increase the lending capacity of the current rescue fund, the EFSF[21], making it able to bail out several eurozone countries if the debt crisis were to continue to spread[22]. They also established the creation of a permanent post-2013 fund − the European Stability Mechanism (ESM) – that will be able to lend up to €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 be only used in a narrow set of circumstances[23], which limit their application and convenience for the struggling countries.

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

[22] 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.

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

The agreement reached by eurozone's leaders was therefore a typical political compromise. Unfortunately, compromise could not necessarily 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 as they rank on the same terms with everybody else's investments. On the whole that means, should the country default, everybody gets hit equally. Creditor nations, such as France and Germany, would not allow a default of a GIPS country (say Greece) until 2013, because it would be a political disaster for their governments. 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 than today to absorb big losses, or so one hopes, therefore there could be the end of crisis. Unfortunately financial markets follow a different reasoning. 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. Thus 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 the game of lending at high interest rates in exchange of austerity plans will continue, until the debtor country's economy collapses under its debt burden, at which point the default will be inevitable and very unpleasant[24].

All debt crises are politically difficult to solve because they involve to make 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 could be, for instance, to accept the principle of a bail-out, not through cross-country transfers, but by means of effective reforms to enable the countries to restructure their economies and of a common European bond that replaces all national debt[25].

Despite the step forward made by the European Council in March 2011 with its measures on crisis resolution, competitiveness. some problems remain unsoved. First, there is still some ambiguity in the economic policy framework, regarding, for instance, fiscal sustainabilty and the new SGP, but also the weight and the role of the national governements relative to European institutions. Second, there is an urgent need to expedite the resolution of the banking crisis. Many European banks still have in their balance sheet too many "toxic assets" and risky sovereign bonds. Third, an equally important

point is that the European authorities must sort out state insolvency cases from illiquidity cases (Greece is likely to find itself insolvent), since this lack of clearness between liquidity crisis and solvency problem is putting at risk the entire system. Fourth, there is the issue of exit strategy for the ECB that needs

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

[25] The idea of Eurobonds is strongly supported by Quadrio Curzio (2010, 2011).

to know how it will get rid of the peripheral bonds on its balance sheet[26]. Fifth, the question of how the euro area periphery will achieve debt sustainability, since there is still no serious answer to the problem of sustainability of public debt yet. Finally, the euro area needs a strategy to revive growth particularly in southern Europe. As I already argued, a coopetitive strategy can be part of this wide strategy for growth.

Conclusions.

The new approach of the governance of EMU, based on the Pact for the Euro, is a partial answer to the persistent crisis of the euro area. But the provided solutions constitute significant corrections as regards some early weaknesses.

So several issues remain open. This contribution has underlined the need of a greater cooperation among the member countries to implement the economic policies, a coopetitive strategy to face some macroeconomic imbalances, a more effective fiscal policy regime. It has also stressed the need for transparency, accountability and a clear solution of the debt crisis. In addition, it is very important the good health of the banking system and the sustainability of the debt burden of the peripheral countries. But it is also crucial a medium term strategy for growth based on reforms that improve competitiveness of the peripheral countries of the euro area and that should help the economies of the EMU grow out of increased public debt·

However, the feeling is that the European authorities still believe not to have governance mechanisms capable of making important decisions. Besides, the weak and divided EU institutions have tax revenues of less than 2% of European

[26] The ECB holds 49 billion euros of sovereign greek bonds.

GDP. Moreover, any major decision requires unanimity. In fact EU institutions follow a quite irrealistic motto which is "all for one and one for all", regardless of flow, the debt position and transparency. Finally, the national interests are too strong and prevail over the European institutions.

In conclusion, in this contribution I envisage the idea that if the Economic and Monetary Union likes to survive in the medium-long term, it will be necessary that the European institutions must provide an effective crisis resolution system, based on an European Monetary Fund with a common European bond ('Eurobond'), that can finance the sovereign debt of the member countries and that can also finance the investment in infrastructure in the EU. It is also necessary a better fiscal policy co-ordination, which should take in perspective towards a fiscal union. In addition, the governance of the EMU must ensure more transparency, demand greater accountability from member countries, make reforms to enable the countries to restructure their economies, promote a real cooperation among the member states, without becoming a transfer union, that is, a monetary union which merely transfer resources.

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