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A NEW GOVERNANCE FOR EMU

AND THE ECONOMIC POLICY FRAMEWORK

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Abstract

The severe crisis affecting European Monetary Union has emphasized the prevailing interests of national governments and the lack of political leadership of European institutions, not to mention the failure of eurozone governance in terms of effective crisis management.

The present work argues that the decisions taken in March 2011 by the European Council, namely the 'Pact for the Euro', to design the new governance of European Monetary Union (EMU), can be considered a necessary though insufficient step for European institutions in terms of credibility and legitimacy. By assessing the economic policy framework set up by the Pact for the Euro, this contribution underlines the need for appropriate institutions, and a stronger attitude of cooperation among Member States. It also stresses the need for transparency and a non-ambiguous solution to the debt crisis. The major message of this work is that Economic and Monetary Union must equip itself with the appropriate policy tools to manage and resolve the crisis, creating the conditions to improve the competitiveness of the peripheral countries of the eurozone and fostering growth. At the same time, however, eurozone member states and European institutions must demonstrate greater accountability and political coherence.

Keywords: EMU, Pact for the Euro, European integration, European institutions, economic policies.
JEL Classification: E63, F15, F33, F36, F6, O52

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Introduction

The severe crisis affecting European Monetary Union (EMU) has shown that European institutions are hesitant and lacking in real political leadership. At the same time it has emphasized the prevailing interests of national governments, and the failure of eurozone governance in terms of effective crisis management.

The decisions made in March 2011 by the European Council, namely the 'Pact for the Euro', to design the new EMU governance can be considered a necessary yet insufficient step by the European institutions in terms of credibility and legitimacy. The Pact for the Euro is an attempt to provide member states of the eurozone with new and effective national budgetary rules, crisis management and resolution principles and procedures, and a wider economic policy framework. However, several questions remain open.

The present contribution examines the debate and proposals regarding EMU governance. In addition, in its critical evaluation of the economic policy framework set up by the Pact for the Euro, it underlines the need for appropriate institutions, and greater willingness to cooperate among the member states. The main message of this work is that Economic and Monetary Union must equip itself with appropriate policy tools to manage and resolve the crisis, whereas eurozone member states and European institutions must demonstrate greater accountability and political coherence.

1. Eurozone governance and the global crisis

European Monetary Union is an incomplete system, as Eichengreen and von Hagen (1996) make clear, since it is based on monetary union without fiscal union. This peculiar 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. Fiscal discipline of the member states is based on the Stability and Growth Pact (SGP), which in practice lacks an effective enforcement mechanism[1]. Coordination of national fiscal policy is facilitated by the Euro group (i.e. 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 establishes that national governments

[1] France and Germany were the first two countries to fail to comply with the SGP, as in 2003-04 they lobbied to change the original SGP, to make it 'more flexible'. Thus in March 2005 the European Council reformed the SGP in order to improve the implementation of the Pact in accordance with the Lisbon strategy and, therefore, to extend its targets (Schilirò, 2006).

alone are in charge of their budget and that no European government or official institution is allowed to rescue another eurozone member with public debt difficulties[2]; ii) the ECB is barred from financing public debts.

Banking and financial market regulations are left up 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 were quite satisfactory until the emergence of the global crisis. The inflation rates of the entire eurozone were close to the target of the ECB. The adoption of the euro has also facilitated structural reforms in product markets[3]. Over the last decade the eurozone has enjoyed a 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 international monetary system, albeit not replacing the dollar as the main currency of the whole system; in fact, it has carved out a significant place beyond the borders of the eurozone in the strictest 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 eurozone have relied on state spending to drive growth, so they have reported a high deficit/GDP ratio and rising public debt. The average deficit/GDP ratio for the whole eurozone was 6.8% in 2009. Moreover, most countries also increased their debt; in fact only six countries out of sixteen had a debt/GDP ratio which was lower than 60% in 2009[5]. The debt situation, however, worsened in the eurozone in 2010 (Eurostat, 2011). The euro zone GDP, instead, has been growing far less than budget deficit 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: Greece, Ireland, Portugal and Spain – the 'GIPS'– were spending and living beyond their means by accumulating private and/or public debt and running large current account deficits. International capital markets reacted by demanding risk premiums for continuing to hold the public debt of GIPS.

[2] The clause really expressed a 'no co-responsibility' principle for public debts (Art.125 of the Treaty), although any eurozone country could request assistance from the IMF.

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

[4] Actually, there have been growing current account imbalances between the northern and southern countries of the eurozone over time (Holinski et al. 2010).

[5] From 1980 to 2007 nearly all the OECD governments increased their indebtedness ratio; this happened because short-term economic needs and electoral interests prevailed over long-term sustainability issues.

The behaviour 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 a result, the vision of EMU governance and its principles has changed significantly and 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 global crisis

Following the global crisis, the institutions of the European Union and individual member countries took a number of economic policy measures to start the process of adjustment and to try to solve the difficult economic and financial situation. In the spring of 2010 the EU, together with the IMF, decided on a programme of financial aid to help Greece, since the country was on the verge of insolvency. To overcome the no-bailout clause, the European Council approved financial aid in the form of 'coordinated bilateral loans' at non-discounted interest rates[6]. Another important measure was the ECB's 'securities market programme' by which ECB decided to buy the government debt of fiscally 'challenged' countries[7]. Subsequently, also the 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 the European Union agreed to create a comprehensive rescue package, a legal instrument aimed at ensuring financial stability in Europe. Thus the European Financial Stability Facility (EFSF) was started to give credits to countries in financial troubles[8]. The EFSF was devised in the form of a special purpose vehicle (SPV) that would sell bonds and use the money it raised to make loans to eurozone nations in need. The bonds are backed by guarantees given by the European Commission representing the whole EU, the eurozone member states, and the IMF. The EFSF will sell debt

[6] In April 2010 Greece requested payment of the 'loans', which was approved unanimously by the European Council. However, the interest rate of the loans by the member 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 buys risky assets issued by a fiscally troubled government of the eurozone and, via its sterilization operations, sells its claims on banks, which is equivalent to selling new assets. This move might be viewed as an improper risk transfer.

[8] The EFSF became operative in August 2010. It bases its rules of the crisis management regime on the principles and procedures of 'IMF doctrine'. The EFSF operates in the event of unsustainable fiscal policies and sovereign debt crises. Thus the Greek bailout was followed by an €85 billion rescue package for Ireland in November 2010.

only after an aid request is made by a country. The European Financial Stability Facility should expire in 2013.

3. Institutional and economic issues concerning the eurozone crisis

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

Barry Eichengreen (2009) has correctly underlined the need for Europe to build up the institutions of its monetary union to avoid similar crises in the future. After all, the Treaty of Lisbon of 2007 left economic governance unchanged and it has remained incomplete and weak. This is demonstrated by the gap between the economic policy based on cooperation between member states, in which the autonomy of national governments has been maintained, and a monetary policy common to all States adopting the euro managed by the ECB.

It is possible to cite some examples of the inadequacy of the institutional architecture. First, the relationship between the member states of the eurozone 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 interests of Europe and within the European institutions. Second, the European Union decides on a growing number of economic policy issues without having a policy at European level, while at national level it has defined policies without being able to find practical solutions to implement them. This mismatch, whose effects are clear in the euro crisis, creates an unstable environment and a variety of problems. Third, there is a certain awkwardness in the position of the ten member states of the non-eurozone, who sit on the European Council but do not express themselves on issues concerning the eurozone, although such decisions also influence the non-eurozone members. There is, therefore, a problem of transparency and legitimacy in the decision-making process at an institutional level.

Fiscal policy is another controversial point. The original sin of fiscal policy in the eurozone is the weakness of its framework of coordination between the member states. The SGP lacks binding rules that make its enforcement effective; moreover the system reveals a lack of transparency. However, there is 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 the 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 national fiscal policy. Weber (2010), instead, is against any discretionary decision concerning the sanctions. He suggests installing 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 eurozone could be less severe if the banks had been strong enough and not interconnected with sovereign debt[11]. Thus many scholars have argued that the main causes of the crisis were the increasing debt and the serious difficulties of the banking system, which were inevitably intertwined. The fragility of banks and their interconnectedness with the debt crisis created a severe macroeconomic problem. During the crisis the governance of the eurozone revealed the lack of a coordinated banking policy, which is crucial for crisis management. Moreover, according to Baldwin and Gros (Baldwin et al., 2010, p.16):

banking policy failed to provide capital cushions large enough to absorb a GIPS debt crisis without putting the core nations' banking systems at risk.

Thus an important economic policy target to avoid crises is to maintain the stability of the 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 post-EMU-launch bond yields, which left the 'GIPS' countries borrowing at rates little higher than those of Germany, leading to large speculative inflows, higher wages and a loss of competitiveness.

[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 northern countries of the eurozone (especially France and Germany) are largely exposed to the peripheral countries.

But a major reason why the global financial crisis struck the eurozone so 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.

Pisani-Ferry (2010) has argued that it is necessary to reformulate the economic policy framework, also taking into account the problems of competitiveness, of trade imbalances and of low and uneven growth inside the eurozone[12].

4. Debt crisis management proposals

Outlined below are some specific proposals on debt crisis management, offering the most appropriate solution to deal with it.

Gianviti et al. (2010) start from the consideration that EU members have agreed to cooperate through supranational institutions within a common legal framework. Gianviti and his colleagues propose the creation of a European Crisis Resolution Mechanism (ECRM), established by a treaty, containing rules for the provision of financial assistance to eurozone countries as a step towards resolving the crisis in an effective and foreseeable way[13]. The ECRM includes procedures for conducting negotiations between a sovereign debtor with unsustainable debt and its creditors, leading to, and enforcing, an agreement on debt restructuring, in order to re-establish the sustainability of its public finances[14]. The ECMR acknowledges the possibility of a government defaulting on its debt. This possibility of default is a warning to creditors, so that they will differentiate between sovereign debt issuers.

Gros and Mayer (2010) make a slightly different proposal for debt crisis management. They suggest the creation of a European Monetary Fund (EMF), set up under the concept of 'enhanced cooperation' established in the EU Treaty and aimed at financing a mechanism capable of managing the orderly default and debt restructuring of a government within the EMU[15]. The design of the EMF considers the organization of this orderly sovereign default as a measure of last resort and it implies some effective enforcement mechanisms. Furthermore, the funds are structured in such a way as to minimize moral hazard[16]. An important result of the creation of the EMF is that it would contribute decisively to the release of the ECB from

[12] Moreover, a policy regime is only complete if it suggests appropriate behaviour in different conditions (in both good and bad times). Pisani-Ferry and Sapir (in Pisani-Ferry, Posen 2009, p.71) argue that the qualities expected from a policy system in times of crisis are clearly different from those expected from the same system in normal times.

[13] Gianviti et al. require that when a country is found insolvent, the provision of financial aid should be conditional on the agreement between the debtor and the creditors to re-establish solvency. The task of supplying financial assistance could be given to the ESFS provided that it is made a permanent institution of the European Union (2010, p.5).

[14] The Court of Justice of the European Union is the natural institution to deal with such cases (Gianviti et al., 2010, p.4).

[15] Gros, Mayer (2010, p.5).

[16] Gros and Mayer are aware that the moral hazard problem can never be completely neutralized, but their proposal limits it.

her improper role as a bad bank[17]. Finally, the EMF is designed to let debtor countries and creditors participate in the costs of sovereign default according to the costs-by-cause principle (Belke, 2010).

Among the proposals for the governance of sovereign debt in the eurozone is the idea of creating a common or centralized public debt instrument, establishing a single issuer of sovereign debt, since eurozone government bond markets remain fragmented. Testifying to this fragmentation are persistent interest-rate differentials which, during the 2009 crisis, widened from less than 30 basis points one year after the introduction of the euro, to 300 basis points for Greece and 150 basis points for Italian bonds[18]. A European government bond ('Eurobond') jointly issued by the eurozone member states, if appropriately designed, could offer significant advantages in terms of efficiency to the issuing governments of the eurozone, but also to investors and financial intermediaries, and it could contribute to fiscal stability. As Favero and Missale (2010, p. 91) maintain:

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.

It is possible to distinguish between several types of Eurobond[19], but Favero and Missale argue that a Eurobond issued by an EU institution (and probably by all eurozone member states) would be perceived as being of the highest credit quality and could compete with the US Treasuries.

Many proposals have been put forward on Eurobonds: Gros, Micossi (2009); Boonstra (2010); Delpla, von Weizsäcker (2010); Junker, Tremonti (2010); Quadrio Curzio (2011); Bini Smaghi (2011). In particular, Delpla and von Weizsäcker (2010, 2011) propose Blue Bonds to tackle the sovereign debt crisis and allow the countries of the eurozone to return to fiscal sustainability. They suggest that sovereign debt in these countries can be split into two parts. The first part, the senior 'Blue' tranche of up to 60 percent of GDP, would be pooled among participating countries and jointly and severally guaranteed: thus it constitutes a common European government bond. The second part, the 'Red' tranche which is the national debt beyond a country's Blue Bond allocation that should be issued as national and junior debt, would keep debt in excess of 60 percent of GDP as a purely national responsibility. This

[17] Intervening in the secondary market of government bonds, the ECB funds *'de facto'* government deficits and thus helps countries in financial distress.

[18] The Greek crisis led the Greek spread to a value of nearly 1000 basis points, affecting also the Italian spread, which reached almost 200 basis points (Favero, Missale, 2010).

[19] Favero, Missale (2010, pp. 99-100).

proposal has, according to Delpla and von Weizsäcker (2011, p.2), two interesting features. The Blue Bonds would constitute an extremely liquid and safe asset on a par with the US T-bond. This should help the euro's rise as a major reserve currency, enabling the entire eurozone to borrow part of the sovereign debt at interest rates comparable to the benchmark German bond. Furthermore, the Red Bonds would help to enforce fiscal discipline. They would make borrowing more expensive at the margin. In any case the Red Bonds cannot be bailed out by any EU mechanism (i.e. EFSF, etc.).

The Quadrio Curzio (2011) proposal of a UnionEuroBond, instead, has broader goals. This proposal is based on the creation of a Euro-Development Fund (EDF) with assets consisting of the gold reserves of the eurozone countries and with a governance where the weight of each member state is related to its GDP. This Fund can issue public debt securities. Financial resources, collected with the issuance of securities, are intended in part to fund the national public debt securities, paying a lower interest rate than the current one, partly to help the European banking system and European industry and partly to finance the infrastructure within the UE, which is an old idea of Jacques Delors.

The first argument against the Eurobond is that its launch would add a new market to the existing national markets and therefore increase fragmentation. Thus the Eurobonds should replace national bonds on a large scale and quickly create a thick market to promote market integration, enhance liquidity and provide a safe-haven international benchmark. However, the transition process can involve high initial set-up costs[20]. A second criticism is that the management of each member state's total debt could become more complex, since centralized funding would raise coordination issues and would reduce flexibility in the pursuit of country-specific debt management objectives. A third argument is that Eurobonds (like, for instance, the Blue Bonds) tend to be overly generous towards weaker countries in terms of access to borrowing. Moreover, the Eurobond solution could become a trap in the medium-long term for the weaker countries if fiscal adjustments were unsuccessful. In fact these countries would eventually be forced to issue domestic bonds at conditions which are even more prohibitive than the present ones. Finally, the real political obstacle for Eurobonds is the EU Treaty, which would have to be amended[21]. Related to the latter criticism is the view that Eurobonds determine a sort of socialization of interest, i.e. debtor countries charge the creditor countries for the cost of the debt. This result does not appeal to creditor countries like Germany, since legitimately they would refuse a monetary union were it to become a mere transfer union.

[20] Favero, Missale (2010, 103)

[21] By pooling fiscal policy, the Eurobonds would require changes to the treaty which it seems doubtful that all 27 members would accept. A solution could be a new Treaty for the eurozone.

Nevertheless, the Eurobonds, depending on the way in which they are conceived, could be a useful instrument for overcoming the debt crisis. However, they become truly helpful only within a comprehensive and credible economic policy framework and a new strategy of EMU governance.

5. Towards new EMU governance

The persistence of the crisis in the eurozone has pushed the UE institutions and member states to take action. The European Council, therefore, made two relevant decisions in March 2011. The first was a new competitiveness pact, called 'A Pact for the Euro', the second an agreement regarding the funding of a permanent eurozone rescue fund, the European Stability Mechanism (ESM). The ESM agreement, which implies a small Treaty change permitted by the simplified treaty revision procedure[22], is part of a wider deal on measures to ensure the stability of the eurozone and improve economic coordination.

The European Commission, back in 2010, stated that there are two other important objectives of economic policy in addition to price stability and fiscal discipline: one is financial stability, which has become evident and necessary following the crisis, the other is the avoidance – or at least the limitation – of macroeconomic imbalances. The recent measures, taken in March 2011, are aimed at completing 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 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 towards crisis prevention 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 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 rooted in a lack of budgetary discipline. It is now agreed that financial stability and

[22] The simplified treaty revision procedure requires, however, a unanimous decision of the European Council and does not enter into force until it is approved by the member states in accordance with their respective constitutional requirements.

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

macroeconomic stability also matter. The Pact for the Euro commits the euro partners to closer economic coordination 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 principle without real enforcement[24].
Since the Pact for the Euro focuses on competitiveness and envisages an EMU that will not become a transfer union, Carfì and Schilirò (2011a, 2011b) suggest an approach based on co-petition. First, they point out the primary role of competitiveness in determining growth and the important relationship between competitiveness and macroeconomic imbalances. Carfì and Schilirò have argued that to overcome macroeconomic imbalances a medium term strategy for competitiveness and growth is necessary, 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 co-petitive strategy. This implies a cooperative attitude aiming at growth among the member countries of the eurozone, despite their divergent interests. The co-petitive strategy will provide players with a *win-win solution* and could constitute a new macroeconomic policy tool to help solve the imbalance problems and contribute to overcoming the economic crisis in a medium-term perspective[25].
However, the measures concerning the crisis resolution, which encompass the creation of a permanent eurozone rescue fund – the European Stability Mechanism (ESM) – contribute significantly to outlining the new governance of the EMU.
First, the SGP was improved and toughened, but the new SGP does not dispose of any mechanism to override national sovereignty. It has thus become a complement to the government insolvency mechanism. Second, it is known that the Maastricht Treaty’s no-bailout clause, which limited cooperation between the member countries of the European Economic Monetary Union, stressed the individual responsibility of the governments and emphasized a strong faith in the market’s capacity to overcome any difficulties. This clause turned out to be too rigid and unrealistic in times of crisis. Similarly, the new rules of EMU governance have transformed the old no-bailout clause into another unrealistic rule concerning the crisis resolution. In fact, the leaders of the eurozone committed themselves to increasing the lending capacity of the current rescue fund, the EFSF[26], enabling it to bail out several eurozone countries if the debt crisis were to continue to spread[27]. They also

[24] Germany and the President of the ECB, Trichet, backed a more binding version that included the possibility of sanctions for violators.
[25] Carfì, Schilirò (2011, pp. 5-6, pp. 17-18)
[26] From about €250bn to its full, headline level of €440bn.
[27] 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 became the third in April 2011.

established the creation of a permanent post-2013 fund – the European Stability Mechanism (ESM) – which 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 only be used in a narrow set of circumstances[28], which limit their application and convenience for struggling countries.

The agreement reached by eurozone leaders has been a typical political compromise. Unfortunately, compromise does not necessarily work in a debt crisis. There are, in essence, two ways to solve a debt crisis: through a bailout or through default. The leaders of the eurozone came to an arrangement which is merely an emergency facility and constitutes a scarcely credible intermediate solution between bailout 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 as everybody else's investments. On the whole, this means that, 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 the ESM's credits will be superior 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 it is hoped; this could therefore be the end of the 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 over, so the game of lending at high interest rates in exchange for austerity plans will continue, until the debtor country's economy collapses under its debt burden, at which point default will be inevitable and very unpleasant[29].

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

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

All debt crises are politically difficult to solve because they involve making choices about who – the borrowers, the lenders or the taxpayers – will ultimately bear the burden of the accumulated debt. The comprehensive solution to the eurozone 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 bailout, not through cross-country transfers, but by means of effective reforms to enable countries to restructure their economies and keep their budget in balance, and also of a common European bond that replaces all or part of national debt[30].

Despite the step forward made by the European Council in March 2011 with its measures on crisis resolution and competitiveness, some problems remain unsolved. First, there is still some ambiguity in the economic policy framework, regarding, for instance, fiscal sustainability and the new SGP, but there is also a lack of clarity regarding the weight and the role of the national governments towards the 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 distinguish between state insolvency cases and illiquidity cases (Greece is likely to find itself insolvent), since this lack of clarity is putting the entire system at risk. Fourth, there is the issue of an exit strategy for the ECB for getting rid of the peripheral bonds on its balance sheet[31]. Fifth, 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, keeping the public budget in balance. As I have already argued, a co-petitive strategy can be part of this wide strategy for growth.

Conclusions

The new governance of EMU, based on the Pact for the Euro, is a partial answer to the persistent crisis of the eurozone. The solutions provided go some way to correcting previous weaknesses. However, several issues remain.

This contribution has underlined the need for greater cooperation between the member countries to implement economic policies, a co-petitive strategy to face some macroeconomic

[30] Despite criticisms, the idea of Eurobonds has many supporters like Monti (2010), Junker and Tremonti (2010), Quadrio Curzio (2010, 2011).

[31] The ECB holds 49 billion euro of sovereign Greek bonds.

imbalances and a more effective fiscal policy regime. It has also stressed the need for transparency, accountability and a clear solution to the debt crisis. In addition, the good health of the banking system is very important as is the sustainability of the debt burden of the peripheral countries. Just as crucial is a medium-term strategy for growth, based on reforms that improve the competitiveness of peripheral countries of the eurozone, which should help the economies of the EMU grow out of public debt.

However, the feeling is that the European authorities still believe they do not have the necessary governance mechanisms for making important decisions. Besides, the weak and divided EU institutions have tax revenues of less than 2% of the European GDP. Furthermore, any major decision taken by the EU institutions requires unanimity and this rule applies regardless of the debt position of the member countries, without transparency. Finally, national interests are too strong and tend to prevail over the European institutions.

In conclusion, in this contribution I envisage the idea that for Economic and Monetary Union to survive in the medium-long term, the European institutions must provide an effective crisis resolution system, based on a European Monetary Fund that can issue a common European bond (‘Eurobond’), but within a new governance strategy. The necessary condition for the success of this crisis solution is better and more effective fiscal policy coordination, which keeps the national budget of the euro countries in balance. However, in perspective, the EMU should overcome its asymmetric and incomplete architecture at institutional level and move towards 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 and promote real cooperation between the member states, without becoming a simple union which transfers resources.

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