Rules, Imbalances and Growth in the Eurozone

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Abstract

This paper highlights the rules and institutions that have characterized the European Monetary Union during its prolonged crisis and discusses the policies implemented in the Eurozone, stressing the limits of the strategy pursued by the European authorities. It also examines the issues of current account imbalances, economic growth and the problem of debt, and their interconnections. The main purpose of the paper is to indicate some economic solutions and political arrangements in order to complete the institutional system of the EMU. This requires appropriate reforms of its institutional architecture, where a key point is fiscal union. But such reforms require changes in the treaties in order to make the Eurosystem more consistent and endowed of democratic legitimacy, so to have the tools, resources and policies necessary to contribute to the development, stability and cohesion of the Eurozone countries.

Keywords: rules, institutions, current account balance, sovereign debt, growth, Eurozone
JEL Classification: E60, F32, F53, F55, H63, O43

1. Introduction

The Eurozone has been facing a double crisis since 2008 – on the one hand the global economic crisis and on the other its own crisis. Both crises have had the finance and financial markets at the center stage. More specifically, the Eurozone revealed deep financial vulnerabilities since its institutional architecture was set up without appropriate defences. However, the Eurozone crisis is a complex, multi-faceted phenomenon, involving a burgeoning, and - in the emblematic case of Greece - unsustainable, sovereign debt. It is also characterized by large account imbalances, banking sector difficulties, lack of financial stability, divergent economic conditions of the northern countries of the Eurozone from those of the south, weak or absent growth, high levels of unemployment (in particular long-term and youth unemployment), increasing poverty and social exclusion, demographic downturn, and by the more recent dramatic phenomenon of an increasing number of migrants and refugees. Last but not least, there is the hesitant role of European institutions and their problem of democratic legitimacy and accountability (Schilirò, 2013).

The euro crisis has exacerbated the tension between economic integration and political harmonization which has existed since the outset of the single currency. The European authorities have shown that they do not have an effective strategy to tackle the crisis, whilst the institutional architecture of the European Monetary Union (EMU) has not helped the economic recovery of the Eurozone. Particularly, the case of Greece and the repeated mistakes to solve the country's economic situation is the most striking example of the inadequacy of the European institutions in managing the monetary union in a fair and efficient way. During the five years of crisis many things have changed in the governance of the Eurozone. Today, the institutional context is quite different compared to the onset of the crisis. Furthermore, the Eurozone has been experiencing a modest recovery in the last two years, as monetary policy is currently loosening and fiscal policy is getting more flexible and tend to align to the former. But the Eurozone's GDP is still not back to its pre-crisis trend, and unemployment and several fundamental issues have not been tackled. The crisis, therefore, is not over yet.

This paper highlights the rules and institutions that have characterized the EMU during its prolonged crisis and discusses the policies implemented in the Eurozone, stressing the limits of the strategy pursued by the European authorities. It also examines the issues of current account imbalances, economic growth and the problem of debt, and their interconnections. The main purpose of the paper is to indicate some economic solutions and political arrangements in order to complete the institutional system of EMU. This requires appropriate reforms of its institutional architecture, where a key point is fiscal union. But such reforms require changes in the treaties in order to make the Eurosystem more consistent and endowed of democratic legitimacy, so to have the tools, resources and policies necessary to contribute to the development, stability and cohesion of the Eurozone countries.

2. Rules, policies and institutional flaws in the Eurozone

The Treaty on the Functioning of the European Union (Lisbon Treaty), the current legal framework[1], was not suited to dealing with the legal and political complexities of the crisis. The

[1] The Treaty signed in Lisbon became operational on 1 December 2009. It amended and replaced the Maastricht Treaty.

Treaty contains the no-bailout clause[2] that makes it illegal for one member state to assume the debts of another, but also the no-exit clause that impedes a member country of EMU to abandon the euro. Furthermore, the Treaty, with its fiscal rules and clauses, eliminates the possibility of fiscal stress: therefore, an implied clause of no-debt restructuring and no-need for default on obligations to private creditors was actually operational. From the outset of the crisis in 2009, several observers noticed that there was a logical inconsistency concerning these three principles underpinning the euro. The difficult days of the Greek crisis have dramatically highlighted this inconsistency in the institutional architecture and the need to resolve it.

Before the crisis, EMU's governance was built on the assumption that it could be grounded on rules-based prevention only, and there would be no need for crisis management (Pisani-Ferry, Sapir, Wolff, 2012). It was also assumed that safeguards against inflation and excessive government deficits would suffice to guarantee macroeconomic stability (Obstfeld, 2013). The governance was based on decentralized policy-making. Fiscal responsibility remained at national level, while, at the same time, national authorities were deprived of the exchange-rate instrument and national discretion over last resort lending for macroeconomic management. The ECB, an independent official EU institution, would handle the single currency and the monetary policy with the narrow remit of ensuring price stability[3]. Consequently, monetary policy results independent from fiscal policy[4]. In the design of EMU, the ECB did not monitor the banking sector, since bank regulation and resolution, but also the regulation of financial markets, were left to national governments. Although in the years before the crisis, the increasing integration of Eurozone financial markets determined a growth in capital flows and banking − an increase that undermined the ability of some member states to backstop their national banking system − there was no strategy in terms of harmonization of rules and surveillance of the financial sector in the EMU. In short, the stabilizers that existed at the national level prior to the start of EMU were stripped away from member states without being transposed at the monetary union level. This left the member states unable to deal with the coming national disturbances (De Grauwe, 2013). But even more, financial deepening reached a certain level within the monetary union, due the concurrent progress of financial integration and financial sector growth, and it left the Eurozone facing a *policy trilemma*. As Obstfeld, (2013, p.3) explains: one cannot simultaneously maintain all three of (1) cross-border financial integration, (2) financial stability, and (3) national fiscal independence[5]. The growth of the balance-sheets in the banking system is a related aspect of financial deepening that gave rise to the "doom loop", linking the solvency of banks to that of the sovereign debt (Obstfeld, 2013).

When the political contract of EMU was signed at Maastricht, the member states (under the pressure of Germany and other countries), for fear of having to pay for the mistakes of others, decided not to contribute to a pool of sizeable centralized resources to relieve acute pressures on the member states in difficulty (Mody, 2015). In addition, the original institutional framework did not take adequate account of the extreme scenario of a member state becoming insolvent and especially of the repercussions of this extraordinary event on financial stability. The rules imposed on the

[2] TFEU, Article 125.

[3] Article 127(1) of TFEU.

[4] The ECB's conduct of monetary policy in the pre-crisis years was founded on temporary credit operations in the form of repurchase agreements, or *repos*. Thus the implementation of monetary policy via *repos* was reflected in the short-term interest rate that is charged under the main refinancing operations (MROs).

[5] Obstfeld (2013) observed that a country reliant mainly on its own fiscal resources will likely sacrifice financial integration as well stability, as it is true in the Eurozone, because markets will then assess financial risks along national lines.

member countries have been devised to preserve this system, not to favour political integration and social cohesion among those countries. But this form of EMU's institutional framework was not sustainable. In fact, it encouraged the accumulation of lasting imbalances at the expense of the Eurozone's weaker countries and determined a widespread dissatisfaction towards the single currency and its system of rules. In short, the Eurozone revealed itself as a non-accomplished common economic system.

During the crisis, which has manifested deep and lasting, the Eurozone governance proved to be inadequate and its single currency was put at risk. In the meantime, institutional architecture and governance have gradually strengthened as regards crisis prevention and crisis resolution, although these necessary actions have not been sufficient to provide stability and development to most of the countries of the Eurozone. The unresolved tension and confrontation between the national interests of member states and the European institutions have highlighted the inconsistency of the institutional architecture of the monetary union and the need that the current reforms should be complemented by a long-term strategy for completing the EMU. Thus a different approach to the political governance of the union should become a priority. The monetary union has been characterized by the emergence of the German government as the leading player in the complex institutional situation where the intergovernmental decision-making system (embedded in the Lisbon Treaty) has dominated the so-called Community method, i.e. the co-legislative decision-making system of the European Parliament, the Council and the executive role of the European Commission. Consequently, the decision-making system of the European Union has revealed its antidemocratic nature, posing a problem of legitimacy (Montani, 2015). The intergovernmental system has caused direct clashes between national governments, which citizens perceive as the revival of national rivalries. In this context the Eurozone is suffering a substantial democratic deficit that Germany is exploiting *de facto*, thus becoming "the semi-hegemonic power of the monetary union" (Montani, 2015, p.2). Therefore, it is necessary and crucial to reshape the institutional framework with a long-term view, especially with regard to political and fiscal union, so that the Eurozone can aim at stability and growth on a lasting basis. However, achieving this goal is not an easy task. It requires a deep change in the governance of the euro that should be established at supranational level on a solid legal basis. This, in turn, requires Eurozone member countries to give up much of their sovereignty, while calling for a clear sharing of resources. In addition, an explicit commitment to common objectives is necessary not only in economic and monetary policy but also in the political and social sphere. Consequently, this new pact calls for a profound change in the European treaties (Schilirò, 2014).

One essential aspect of the Eurozone is that it has not been homogenous since the outset of the monetary union (Schilirò, 2013a). The monetary union was expected to reduce the degree of divergence in the Eurozone. However, the introduction of the internal market and the single currency did not lead to real convergence through capital flows towards lower-income economies, nor to convergence in productivity; neither did it lead to greater financial integration, nor to increased efficiency and fairness in the social sphere. The crisis has exacerbated this situation. Therefore, a high degree of divergence has remained between the peripheral economies and the core countries of the Eurozone in terms of unemployment, investment, growth and other real indicators.

3. The new institutional framework of the Eurozone. Is it enough?

During the crisis, relevant decisions were taken by the European authorities in order to stabilize the economies of the peripheral countries and the single currency. Thus, if we look at the evolution of governance and institutions in the Eurozone and consider the policies implemented during the five years from the start of the euro crisis we face a changed environment. Let us look at the new institutional framework and let us see whether it is a complete and sufficient solution.

In the first place, in the European summit of March 2011 in Brussels, the heads of state or government of the Eurozone decided a plan for competitiveness and convergence ("Pact for the Euro") and an agreement regarding the funding of a permanent Eurozone rescue fund, as a part of a wider deal on measures to ensure the stability of the Eurozone. So a design of the Eurozone risk management was worked out, based on fiscal consolidation aimed at restoring debt sustainability, while official loans were intended to support the distressed economies until they were able to return to fiscal health. Consequently, on 2 February 2012 the intergovernmental Treaty establishing the European Stability Mechanism (ESM) − the crisis resolution mechanism for Eurozone countries − was signed by the Eurozone member states, and in October 2012 the ESM began operating. The ESM provides financial assistance, in the form of loans, not only to Eurozone countries but also to banks in difficulty[6]. At the same time, the no-bailout clause for member states was maintained because the loans were to be repaid (Mody, 2015). On the contrary, private creditors would be bailed out, unless in exceptional circumstances (as in the case of Greece)[7]. In November 2011, the Commission proposed two further regulations, i.e. the 'Two-Pack'[8], to strengthen monitoring and enhance Eurozone budgetary surveillance. Furthermore, at the European Council of March 2012, the initial fiscal rules contained in the Stability and Growth Pact were strengthened and made mandatory with the Treaty on Stability, Coordination and Governance in the EMU or 'Fiscal Compact'[9] determining a fiscal policy geared to austerity. All these new rules and measures are characterized by the intrusion of EU institutions into national economic policies, where different EU actors play different roles in affecting the definition of those policies.

At the same time, the ECB decided important measures to support financial stability and improve the monetary transmission mechanism, i.e., the Securities Market Program (SMP) and the Longer Term Refinancing Operation (LTRO)[10]. Both measures, however, had limited effects. Thus, on 26 July 2012, in the midst of a dramatic moment for the single currency in which it risked meltdown, ECB President Mario Draghi maintained, during a speech in London, that "the ECB is ready to do whatever it takes to preserve the euro". Therefore, in September 2012, the ECB announced the purchasing programme Outright Monetary Transactions (OMT), a non-standard measure of monetary policy to purchase, in secondary sovereign bond markets and under strict conditions,

[6] The ESM can borrow from international markets, backed by repayment guarantees from member states. Its lending is made on the basis that loans will be repaid. The ESM today is by far Greece's largest creditor. For further details on ESM see Schilirò (2013a) and Obstfeld (2013).

[7] In February 2012, after long negotiations, large private debt restructuring took place in Greece, in which creditors would be paid only half of their claims.

[8] The 'Two Pack', entered into force on 30 May 2013, is a package of rules that gives new powers to the EU Commission including the right to impose changes to the financial laws of the Eurozone member states.

[9] The 'Fiscal Compact' was signed on 2 March 2012 by 25 EU countries and entered into force on 1 January 2013.

[10] The securities markets programme (SMP), launched in May 2010, was aimed at purchasing Member States sovereign bonds. In December 2011 the ECB decided to conduct two longer-term refinancing operations (LTROs) with a maturity of 36 months in order to support bank lending and liquidity in the euro area money market.

bonds issued by Eurozone member states[11]. The OMT, although not tested, did work, mainly through the expectation channel, proving to be sufficient to contain the sovereign credit risk premia. While the Fed and Bank of England decided to use large-scale asset purchases as one of their main tools to fight the crisis, the ECB's policy response to the crisis was mainly oriented towards ensuring the provision of liquidity and repairing the bank lending channel (Claeys, 2014). The ECB provided virtually no stimulus to the economies of the Eurozone, but rather acted as a safety net against bank and sovereign insolvency (Mody, 2015).

Following these changes in the rules governing the EMU and in its fiscal and monetary policies, the prevailing doctrine concerning the functioning of the monetary union was that each member state should promote market competition with effective competitive rules, keep their 'house in order' by fulfilling the fiscal rules oriented towards fiscal consolidation, and implement structural reforms in the case of deficiency of competitiveness. The basic idea behind this doctrine is to make the Eurozone countries less divergent in terms of competitiveness. In short, national governments have to pursue fiscal discipline and supply-side reforms to meet the objectives of the reformed EMU rules (Schilirò, 2014). The diagnosis that focuses on the loss of competitiveness in the periphery as a result of wage growth inconsistent with underlying productivity trends was stressed by Trichet (2011), Werner-Sinn, Valentinyi (2013), Estrada, Galì, Lopez-Salido (2013), and others.

Apart from the new fiscal regime (i.e. the 'Two-Pack' arrangements and the 'Fiscal Compact'), in the European Council on 28/29 June 2012, the heads of state or government of EU countries and the EU authorities agreed to create a Banking Union with the aim of constructing a more resilient system. The Banking Union is the transfer of banking sector policy from national to European level. It is a big step since one of the main goals of the Banking Union is to break the connection between banks and sovereign debt (the "doom loop"). This nexus caused a steep increase in the refinancing cost of public debts in deeply indebted countries, reducing their anti-cycle fiscal capacity. The first step towards the Banking Union was the establishment of a Single Supervisory Mechanism (SSM) under Article 127 of the Lisbon Treaty. The SSM, which became operational in November 2014, implies that the European Central Bank (ECB) has fundamental supervisory responsibilities for all banks in the Eurozone[12]. A second fundamental step to achieve the Banking Union was the creation of a Single Resolution Mechanism (SRM) for banks in the Eurozone countries in August 2014. The SRM applies to banks directly supervised by the European Central Bank as well as other cross-border groups covered by the SSM. In the case of bank failures the SRM would provide appropriate solutions through rescue or liquidation[13]. Moreover, the Bank Recovery and Resolution Directive (BRRD) − Directive 2014/59/EU – was introduced to provide a consistent set of rules[14] regarding bank failure in the 28 countries of the European Union that would prevent the use of taxpayer money in bank bailouts in Europe, since it imposes a bail-in from the private sector. Thus, a single EU authority would have the powers to protect taxpayers from bank failures, ensuring the overall

[11] In summer 2014 the ECB launched the TLTRO, Targeted longer-term refinancing operations, another unconventional measure to enhance the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy.

[12] Colliard (2014) has studied the optimal architecture of the single supervision mechanism (SSM) and argues there is a conflict of objectives between local and joint supervisors.

[13] The centralized decision making is built around a Single Resolution Board. Colon, Cotter (2015) provide an empirical analysis on SRM for European banks.

[14] Since 1 January 2015 all member states have to apply a single rulebook for the resolution of banks and large investment firms, as prescribed by the Bank Recovery and Resolution Directive under the supervision of the European Banking Authority.

stability and transparency of the financial system in the Eurozone, with a positive impact on the entire EU. It is important to notice that the Banking Union and national regulators coexist in this agreement. This has created in the case of Italian banks, which are in difficulty and weighed down by a considerable amount of non-performing loans, the problem of fulfilling the new European rules on the one hand, and on the other the need of preserving the interior financial stability. However, while banking union is a major achievement it remains unfinished, since it should encompass a single and centralized mechanism in deposit insurance. A European Deposit Insurance Guarantee Scheme should constitute the 'third leg' of the Banking Union, but although there is a proposal by the European Commission[15], several member states, including Germany, have expressed their opposition to the European Commission's plan. Noteworthy, a complete Banking Union would have positive implications for the central bank's function as lender of last resort. But a complete Banking Union would require some fiscal capacity (Pisani-Ferri, Wolff, 2012; Obstfeld, 2013). Therefore a true Banking Union should sit within a fiscal union and the latter would require a political union; otherwise, given the current setup of the banking rules, the bank-sovereign vicious circle, which has been correctly identified as a key factor of instability, cannot be eliminated (Pisani-Ferri, Sapir, Véron, Wolff, 2012; Véron, 2014).

In January 2015, the ECB confirmed its major role in contrasting the crisis with its (unconventional) monetary policy. It decided a programme of quantitative easing (QE). The programme started on 9 March 2015 and it was named the Public Sector Purchase Program (PSPP). The decision came after the ECB's core target of inflation, "close to but under 2%", was found to be far from the current state of inflation in the Eurozone. In fact, the Eurozone has officially been in deflation since January 2015 and the target of 2% will unlikely be achieved in the near future. The QE programme commits the ECB to buying Euro 60 billion of assets per month for at least 19 months until September 2016 with an increase in assets of Euro 1.1 trillion[16]. The ECB Governing Council has imposed limits ensuring the ECB will not breach the prohibition of monetary financing[17]. The main purposes of ECB are to stimulate lending and in turn encourage investments in the Eurozone, and to increase inflation expectations to the target of (nearly) 2%. Of course, the ECB's sole objective is the defence of price stability, and not even to support growth. Therefore, in the decision taken by the ECB there is not an explicit link between low growth and new monetary stimulus, but rather one between deflation and monetary easing. In practice, QE operates essentially through the portfolio channel by changing the mix of securities in the market, but also through the expectation channel. The empirical literature has widely demonstrated that central bank asset purchase has had economically significant effects, at least on governments bond yields[18]. There is also some worry that the flood of cash created by QE fuels asset bubbles and encourages reckless financial behaviour. In general, the lower yields and the lower long-term interest rates have somehow determined a positive effect on the economy; but the impact of QE on the economy is difficult to measure (Joyce *et al.*, 2012). Wieladek and Pascual (2016) find that the effect of ECB QE is

[15] On 24 November 2015 the European Commission made a legislative proposal introducing a European Deposit Insurance Scheme (EDIS) as a further step to a fully-fledged Banking Union.

[16] With the QE programme the ECB established, among other things, that securities would be purchased in the secondary market with maturities between 2 and 30 years, be denominated in euro and eligible as collateral for ECB monetary policy operations; in addition they cannot be purchased at a rate less than the deposit rate set by the ECB.

[17] See Claeys, Leandro, Mandra (2015) for a discussion about these limits.

[18] The effects on the sovereign bonds of Italy and Spain since the start of the QE have been very clear and positive. There is instead less consensus on the transmission channels linking asset purchases with asset prices (Joyce *et al.*, 2012).

roughly 2/3 times smaller than in the UK/US, but that in absence of the first round of ECB QE, real GDP and core CPI in the Eurozone would have been 1.3% and 0.9% lower, respectively[19]. Most economists share the view that a quicker implementation of sovereign QE by the ECB could have reduced the debt burden of Eurozone governments by a non-negligible amount at a time when interest rates and deficits were very high (Claeys, Leandro, Mandra, 2015, p.12). However, one year after QE, core inflation in the Eurozone remains below 1%, while the growth remains sluggish and financial volatility high. The expectation channel does not seem to work as it should. Usually inflation expectations must be guided by monetary policy, not vice versa. Thus, on 10 March 2016 the ECB has promoted a package of measureres by expanding the QE, cutting further the interest rates and creating incentives to banks to increase lending[20]. Specifically, the ECB raised the amount of bonds the Eurozone's central banks buy each month under QE from €60bn to €80bn, and it expanded the range of assets it will buy to include high-quality corporate bonds. In addition the main refinancing rate was cut by 5 basis points to 0 per cent and the deposit rate was cut to minus 0.4 per cent. At the same time it made cheaper short-term loans and longer-term liquidity to the banks in order to increase credit to households and companies. The experience of QE in the US, UK and Japan suggests that to emerge from a profound crisis, like the one experienced in the Eurozone, monetary policy is not enough. What is needed is a combination of monetary and fiscal policy (Posen, Ubide, 2014). In conclusion, OMT, TLTRO and QE are unconventional monetary tools that have not only increased the balance sheet of the ECB, but also expanded its role as a central bank, entwining solvency issues with liquidity concerns.

This set of measures of fiscal and monetary policy, as mentioned above, has been deemed relevant and necessary by the European authorities, but it certainly lacked a programme targeted for growth based on investment. For this reason, in November 2014, Jean-Claude Juncker, President of the European Commission, launched 'An Investment Plan for Europe' aimed to mobilize investments of at least €315 billion in three years in the EU economy, since the level of investment in the EU has dropped significantly since 2007. This initiative constitutes an expansive action plan which respects the restrictive budgetary rules[21]. The plan is a positive step, because it could boost the investment in infrastructure that Europe needs most and favor innovative SMEs, but it appears unconvincing and insufficient to stimulate growth. One criticism is based on comparably few EU-budget resources which should raise multiple initial funds (Zeilbeck, 2015). Another criticism is the slow pace of the initiative, since it is starting to become operational more than one year after its conception.

Despite efforts to adapt governance to the problems in the Eurozone and the attempt to adjust the rules to make them more effective in the European Union, a widespread awareness of this seemingly endemic state of crisis is shared not only among citizens but even among the European authorities, and this is reflected in the report drawn up in July 2015 by the five presidents of the

[19]These authors find that the policy is mostly transmitted through the portfolio balance, signaling, exchange rate and credit easing channels. The uncertainty channel does not seem to operate in the case of the ECB's QE.

[20] In December 2015, Draghi already decided to extend the QE programme until March 2017 and cut the ECB's deposit rate to minus 0.3% in order to stimulate lending.

[21] This initiative, through a European Fund for Strategic Investments (EFSI), is aimed at creating an investment-friendly environment by removing obstacles to investment. The plan in practice consists in a €21bn guarantee from the Commission and the European Investment Bank for a total investment capacity in the EU economy of €315bn (European Commission, 2014).

most important European institutions[22]. Although this report aims at completing the EMU through a political and budgetary union, it accepts the German ideology of ordoliberalism, pointing to a political union in the long term when all the member states will have reached the same level of competitiveness and implemented, if needed, deep structural reforms. But the report does not constitute a sufficient response to end the risks in the Eurozone and to its economic and political future.

4. Current Account Imbalances

Economists have focused on different aspects of the Eurozone crisis. Some highlight the debt burden connected with the problems of the banks and the fiscal issue (e.g., Baldwin *et al*., 2010; Cline, 2014; Mody, 2015). Baldwin and Gros (Baldwin *et al*., 2010, p.7), in particular, state that "The crisis is, in our view, a thorny tangle of incipient debt and banking crises". Others place at the centre the current account imbalances, cross-border capital flows and the divergence in competitiveness[23](Werner-Sinn, Wollmershaeuser, 2011; Merler, Pisani-Ferry, 2012; Chen, Milesi-Ferretti, Tressel, 2012; Werner Sinn, H., Valentinyi, A. 2013; Baldwin, R., Beck, T. *et al.* 2015). An eclectic view is provided by Comunale, Hessel (2014). They argue that the link between credit and current accounts has been very important in the Eurozone crisis. By introducing the so-called financial cycle, which is mainly driven by credit and house price growth, these authors show that, although differences in price competitiveness have an influence, differences in domestic demand are more important than is often realized[24]. Thus they call for more emphasis on credit growth and macro prudential policy, in addition to the current attention for competitiveness and structural reforms. However, given the complexity of the crisis and the inter-relationships between the various aspects, we believe many factors have played an important role, but certainly finance and financial markets have been at the center stage.

A shared narrative is as follows: with the introduction of the euro, the favourable financing conditions determined by low-level interest rates in the countries of the Eurozone with previously higher interest rates (usually the peripheral countries) stimulated their domestic demand. In these peripheral countries higher domestic demand led to above-average inflation, and if, on the one hand, nominal interest rates were similar in all countries of the Eurozone, on the other, real interest rates declined further mainly in the peripheral countries. Moreover, higher demand caused wages and then prices to rise, while some structural rigidities hampered adjustment, so that the increase in wages and prices expanded moving from the non-tradable to tradable sectors. Since these countries could not devalue to restore competitiveness, all those factors pushed the real exchange rate up, reducing competitiveness. This had a negative effect on their exports and also caused slower growth. Consequently, peripheral countries built up very large current account deficits and external

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[22] Jean-Claude Juncker, President of the European Commission, Donald Tusk, President of the euro summit, Jeroen Dijsselbloem, President of the Eurogroup, Mario Draghi, President of ECB, and Martin Schulz, President of the European Parliament, presented an ambitious plan for the EMU to complete it at the latest by 2025. This report focuses on institutions, going beyond the rules in order to create an extended and fairer Monetary Union.

[23] Baldwin, Beck *et al*. (2015), searching for a consensus view of the crisis narrative, argue that the real culprits were the large intra-Eurozone capital flows that emerged in the decade before the crisis. According to their view, a balance of payments crisis became a public debt crisis, due to the sudden stop of capital flows that raised concerns about the viability of banks and governments in nations dependent on foreign lending, while slowing growth produced increasing public debt ratios.

[24] Also Mirdala (2015) emphasizes the increased responsiveness of the current accounts to the demand shocks in all Euro Area member countries during the crisis period.

debts (Holinski *et al.*, 2010; Werner-Sinn, Wollmershaeuser, 2011; Cour-Thimann, 2013; Schilirò, 2013b; Higgins, Klitgaard, 2014). However, these countries of Southern Europe have not only supported greater costs but they have been hampered in their ability to stabilize their economy in the event of asymmetrical shocks. This happened because their loss of competitiveness was attributed by the European authorities to the policy mistakes of the government of the peripheral countries; therefore this loss justified the need for fiscal austerity and structural reforms. At the same time the notion that surplus countries might need to make converse macroeconomic adjustments by stimulating demand (through tax cuts, wage rise and investment), as suggested earlier by Adam Posen (2010) and later by the IMF and other economists, was dismissed.
To get a better idea of the imbalances of current account balances in the years preceding the crisis (2004-2007) during the global financial crisis (2008-2009) and during the euro crisis (2010-2014) it is useful to look at Table 1. The Table shows the current account balance of the nineteen countries of the Eurozone[25] with the rest of the world for the years from 2004 to 2014. The figures are in billions of euro.

Table 1
Current account balance of Eurozone countries with the rest of the world, 2004–14
(EUR billion)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Austria	--	--	8.8	10.8	13.2	7.5	8.4	5.1	4.7	3.1	2.6
Belgium	--	--	--	--	-3.5	-3.8	6.4	-4.1	-2.8	-0.9	5.7
Cyprus	--	--	--	--	--	--	-2.2	-0.7	-1.5	-0.6	-0.9
Estonia	-1.2	-1.0	-2.0	-2.4	-1.4	0.4	0.3	0.2	-0.4	-0.2	0.0
Finland	9.2	5.0	6.5	7.2	4.4	3.5	2.3	-3.5	-3.9	-3.5	-3.7
France	7.5	-0.3	0.7	-5.8	-19.0	-16.1	-16.7	-21.2	-32.2	-30.3	-21.4
Germany	100.8	106.1	135.9	169.6	143.3	141.1	145.1	164.6	187.3	182.0	219.7
Greece	--	--	--	--	--	-25.8	-22.5	-20.6	-4.6	1.1	1.6
Ireland	-0.9	-5.8	-6.5	-10.5	-10.7	-5.1	0.9	1.4	2.7	7.6	11.5
Italy	-7.6	-14.0	-23.9	-22.8	-46.3	-30.4	-55.7	-50.4	-8.2	15.0	31.2
Latvia	-1.4	-1.6	-3.6	-4.7	-3.0	1.5	0.4	-0.6	-0.7	-0.5	-0.7
Lithuania	-1.4	-1.5	-2.5	-4.3	-4.2	0.6	-0.1	-1.2	-0.4	0.6	0.0
Luxembourg	3.3	3.3	3.3	3.6	2.8	2.8	2.7	2.5	2.5	2.2	2.5
Malta	--	--	--	--	--	-0.4	-0.3	-0.2	0.1	0.2	0.2
Netherlands	35.4	33.2	45.7	36.7	26.0	35.9	46.4	58.6	70.5	70.4	67.5
Portugal	-12.7	-15.7	-17.7	-17.1	-21.7	-18.3	-18.3	-10.6	-3.5	2.4	1.0
Slovenia	-0.7	-0.5	-0.6	-1.5	-2.1	-0.2	0.0	0.1	1.0	2.0	2.2
Slovakia	--	--	--	--	-4.3	-2.2	-3.2	-3.5	0.7	1.3	0.0
Spain	-48.1	-69.7	-90.6	-104.3	-103.3	-46.2	-42.4	-34.0	-3.0	15.1	8.5
EZ (19)[21]	--	--	--	--	-151.9	-15.7	8.8	7.2	-119.9	185.1	212.7
EU (28)	-43.7	-97.2	-161.7	-167.0	-301.3	-117.6	-108.7	-41.0	95.9	155.5	126.5

Source: Eurostat (2015)_ Balance of payment statistics

[25] Until 2007 there were fifteen countries using the euro. In January 2015 Lithuania was the last country to begin using the euro.

First of all, four countries (Austria, Germany, Luxembourg and the Netherlands) recorded surpluses throughout the period, while Cyprus always recorded deficits. Germany, in particular, showed its strength and competitive superiority with very high balances and a surplus that doubled in the period under consideration, from 100.8 billion in 2004 to 219.7 billion in 2014[26]. The driving factors behind Germany's current account surplus are the strong global demand for quality German exports, domestic wage restraint, an undervalued single currency[27], high domestic savings rate and interest rate convergence towards the German rate in the Eurozone that facilitated the outflow of German savings in the Southern European economies and drained domestic investment (Ji, 2015). However, German manufacturing also exploited the practice of outsourcing to the Easter European countries such as the Czech Republic, Hungary, Poland and Slovakia to reduce costs and improve competitiveness, so these countries became part of the German supply chain, aligned to the economic interests of Germany. An opposite case is Greece. The country registered heavy negative balances in 2009, 2010 and 2011, while in 2012 the current account balance began to improve, and the balances became positive in 2013 and 2014. But the last improvements are mainly due to the austerity measures which have sharply reduced imports. Finally, after 2009, for many countries, especially in the periphery of the Eurozone, we can observe diminishing external imbalances that were probably associated with the spike in real interest rates and severe growth contractions.
As regards the movement of capital between the Eurozone countries during the sovereign debt crisis, capital flows aggravated the difficulties of the peripheral countries since they did not target the more productive sectors, in many cases feeding real estate bubbles. Some peripheral countries, given their large external debts, could not finance their deficits through capital inflows, since a sudden stop in the inflow of private capital was determined by a loss in creditors' confidence regarding the solvency of these countries[28]. This sudden stop required macroeconomic rebalancing and appropriate policies to improve competitiveness. The adjustment process was cushioned by the single monetary policy through harmonized short-term interest rates. Moreover, the ECB offered liquidity assistance measures (i.e.liquidity-providing credit operations, outright transactions, etc.) and through TARGET2, the payment infrastructure of the Eurosystem, financed the current account deficits of the peripheral countries (Schilirò, 2013b). As is clear from Table 1, since 2011 imbalances have been addressed mainly through internal devaluation. Therefore, deficit countries tried to restore international competitiveness by aggressively reducing labour costs, coupled with fiscal consolidation, with the aim of lowering the prices of their products[29]. In any case, the overall short-term effect of this internal devaluation and austerity measures has been to weaken domestic demand. Given the lack of an offsetting increase in external demand, with surplus countries undertaking a reflationary stimulus, these measures have undermined economic growth and hence the public finances of the deficit countries. To restore competitiveness it is necessary, on the contrary, to implement productivity-enhancing reforms to improve long-term economic prospects (Posen, Ubide, 2014). Eurozone member countries have taken the benefits of the single currency for granted without acknowledging their shared responsibility. But the true problem is that Eurozone

[26] During the nineties, after reunification, Germany experienced several years of deficits in its current account balance.
[27] Devaluation became more evident when the quantitative easing (QE) announced on 22 January 2015 by the President of the ECB sent the euro to an 11-year low against the US dollar and the euro hitherto lost 6% of its value in 2015.
[28] Merler and Pisani-Ferry (2012) provide an empirical analysis of these sudden stops in the euro area stressing the role the balance of payment crisis.
[29] Sometimes, as in the case of Greece, wages went down but prices did not, because of lack of competition in the economy.

authorities have been trying to survive the emergencies caused by the crisis following a 'muddling through' strategy, seeking to improve the governance of EMU without changing its purposes and perspectives (Schilirò, 2014).

5. Growth and the Debt Problem

Now we turn to growth in the Eurozone. Table 2 shows the real GDP growth of the nineteen countries of the Eurozone for the period from 2004 to 2014. The last row of Table 2 shows the real GDP growth in the United States for the same years. The figures are a percentage change compared with the previous year. The last column of the Table shows the average GDP growth for the period 2004-2014.

The year 2008 and, to an even greater extent, 2009 were the years of the global financial crisis. This crisis was disruptive and has determined a prolonged recession, so that the GDP in most advanced economies has remained far from its pre-crisis trend; consequently all the countries of the Eurozone have suffered in terms of growth and have recorded negative growth rates. After 2010, while the United States started to recuperate lost ground and the rates of growth turned positive and significant in subsequent years (1.6% in 2011, 2.3% in 2012, 2.2% in 2013, 2.4% in 2014), the Eurozone experienced a double dip recession. Thus its rates of growth in the years after the profound crisis of 2009 were: a partial upturn in 2010 and 2011, negative rates in 2012 (-0.8%) and 2013(-0.4%) and a modest growth in 2014 (0.9%). Furthermore, inside the Eurozone the growth situation has been uneven. In fact, some Eurozone countries have been able to regain lost ground, while other have suffered a sharp setback mainly because of austerity policies implemented by the European authorities.

Table 2

Real GDP growth 2004–14 for Eurozone countries and the United States

(% change compared with the previous year)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2004-14
Austria	2.7	2.1	3.4	3.6	1.5	-3.8	1.9	3.1	0.9	0.2	0.3	1.3
Belgium	3.4	1.9	2.6	3.0	1.0	-2.6	2.5	1.6	0.1	0.3	1.1	1.1
Cyprus	4.4	3.9	4.5	4.9	3.6	-2.0	1.4	0.3	-2.4	-5.4	-2.3	0.6
Estonia	6.5	9.5	10.4	7.9	-5.3	-14.7	2.5	8.3	4.7	1.6	2.1	2.4
Finland	3.9	2.8	4.1	5.2	0.7	-8.3	3.0	2.6	-1.4	-1.3	-0.1	0.7
France	2.8	1.6	2.4	2.4	0.2	-2.9	2.0	2.1	0.3	0.3	0.4	0.9
Germany	1.2	0.7	3.7	3.3	1.1	-5.6	4.1	3.6	0.4	0.1	1.6	1.3
Greece	5.0	0.9	5.8	3.5	-0.4	-4.4	-5.4	-8.9	-6.6	-3.9	0.8	-2.0
Ireland	4.6	5.7	5.5	4.9	-2.6	-6.4	-0.3	2.8	-0.3	0.2	4.8	1.4
Italy	1.6	0.9	2.6	1.5	-1.0	-5.5	1.7	0.6	-2.8	-1.7	-0.4	-0.5
Latvia	8.9	10.2	11.6	9.8	-3.2	-14.2	-2.9	5.0	4.8	4.2	2.4	2.5
Lithuania^	--	--	7.4	11.1	2.6	-14.8	1.6	6.1	3.8	3.3	2.9	2.4
Luxembourg°°	4.9	4.1	4.9	6.5	0.5	-5.3	5.1	2.6	-0.2	2.0	--	2.2
Malta	0.4	3.8	1.8	4.0	3.3	-2.5	3.5	2.3	2.5	2.7	3.5	2.5
Netherlands	1.9	2.3	3.8	4.2	2.1	-3.3	1.1	1.7	-1.6	-0.7	0.9	1.0
Portugal	1.8	0.8	1.6	2.5	0.2	-3.0	1.9	-1.8	-4.0	-1.6	0.9	-0.3
Slovenia	4.4	4.0	5.7	6.9	3.3	-7.8	1.2	0.6	-2.6	-1.0	2.6	1.2
Slovakia	5.2	6.5	8.3	10.7	5.4	-5.3	4.8	2.7	1.6	1.4	2.4	3.8
Spain	3.2	3.7	4.2	3.8	1.1	-3.6	0.0	-0.6	-2.1	-1.2	1.4	0.6
EZ (19)	2.2	1.7	3.3	3.1	0.5	-4.5	2.0	1.6	-0.8	-0.4	0.9	0.7
EU (28)	2.5	2.0	3.4	3.1	0.5	-4.4	2.1	1.7	-05	0.0	1.3	0.9
United States	3.8	3.3	2.7	1.8	-0.3	-2.8	2.5	1.6	2.3	2.2	2.4	1.6

Source: Eurostat (2015a)_ Real GDP growth, 2004–14

Blanchard and Leigh (2012, 2013) produced evidence that austerity caused a significant reduction in the Eurozone's growth, showing that the fiscal multiplier was large[30]. They also showed that the shortfall in growth was greater where fiscal consolidation was larger (in particular, for peripheral countries). Fatás and Summers (2015), extending the methodology of Blanchard and Leigh (2013) to a longer time span, provided further evidence that austerity policies not only caused significant temporary damage to growth but have also permanently reduced output, and this effect for the Eurozone countries was greater after 2012. Also, fiscal consolidation was self-defeating, with negative effects on debt, which has increased rather than been reduced. Moreover, Manasse (2015) demonstrated that fiscal policy has strongly targeted debt sustainability, yet this policy was also largely pro-cyclical during the crisis; thus the economies of Eurozone have diverged in unemployment rates, investments and, at least temporarily, in growth.

As shown in Table 2, the pace of growth in the years 2012-2104 slowed down in all the countries of the Eurozone, even in the countries that performed well after the global crisis. This means that the sovereign crisis and austerity policies have somehow affected the member states that were able to recuperate lost growth. Germany, for instance, after the 5.6% fall in GDP in 2009, recovered in the years 2010-2014 with a cumulative growth of 9.8%, but in 2012 and 2013 it experienced very weak growth (0.4% and 0.1%, respectively). Other countries in the same situation are: Austria, Belgium, France, Ireland, Luxembourg, Malta and Slovakia. Countries instead such as Cyprus, Finland, the Netherlands, Italy, Portugal, Slovenia and Spain not only did not recuperate the loss of the global crisis, but suffered because of austerity policies. Countries like Estonia, Latvia and Lithuania experienced a big drop in the rate of growth both in 2008 and 2009, and have still not reached their pre-crisis level, although they had a strong positive rate of growth in the period 2012-2014. Lastly, Greece was not able to recover from the crisis which began in 2008, apart from a timid 0.8% registered in 2014, despite the bailout programmes; on the contrary the economic situation worsened dramatically in the years 2010-2013. Regarding the current situation and future perspective, the European Commission (2016) shows that, in the Eurozone, real GDP has grown by 1.6% in 2015, while in 2014 the rate of growth was 0.7%, thus indicating a still modest recovery. In 2016 the GDP is expected to grow by 1.7% and in 2017 by 1.9%. For the EU as a whole, the real GDP has grown by 1.9% in 2015 and it is expected to remain at 1.9% in 2016, while in 2017 it should grow by 2.0%. But while the modest recovery in 2014 was driven mainly by external demand (net exports), in 2015 it was supported by internal demand, especially private consumption, since weak global growth and deterioration of world trade are factors hindering recovery. Ireland is the country that registered the best performance (6.9%) in 2015. Other countries with a quite positive growth are Malta, Slovakia, Spain, Luxembourg, Slovenia and Latvia. Greece continues to suffer the most.

One relevant consequence of weak or negative growth over the period 2004-14 concerned unemployment. Manasse (2015) provided evidence that the rate of unemployment in the Eurozone has almost doubled since the crisis, rising from 6.2% in 2007 to 11.8 in 2013 and decreasing slightly since. The difference between the highest rate (in the Slovak Republic and Greece,) and the lowest (Luxembourg), widened dramatically during the crisis, reversing a period of convergence from 2000 to 2007. His conclusion is that if real divergence if not tackled, it can undermine political support for the common currency (Manasse, 2015, p.7). Another negative effect has been that the

[30] The multiplier measures the contraction in growth due to austerity. In this context, if the central bank reduces interest rates to zero, its ability to provide stimulus is limited (Mody, 2015).

debt ratios in the Eurozone in the period 2008-2014 tended to increase, especially for the countries with high initial debts. Undoubtedly, debt is a very important issue and the Eurozone's most pervasive problem. Since the start of the crisis, the debt for the whole Eurozone has risen from 68.5% (in 2008) to 92.1% (in 2014). Currently, a heavy debt burden is affecting much of Europe. Gross government debt is close to, or exceeds, 100 percent of GDP in Belgium, Cyprus, France, Greece, Ireland, Italy, Portugal and Spain. Small countries like Estonia, Latvia, Lithuania, Luxembourg and Slovakia record a gross government debt to GDP ratio below 60 per cent, which is the debt criterion imposed by the fiscal rules for the Eurozone[31]. Sovereign debt has tended to increase in all countries since 2008 because of the effect of the global financial crisis and the upward trend has continued for reasons internal to the Eurozone, such as slow growth, deflation and so on, as already explained (Gianviti, *et al.*, 2010; Schilirò, 2013a; Mody, 2015). Moreover, according to European Commission (2016), in the Eurozone government debt to GDP in 2015 is at 93.5%. This is still a high level, although with a small improvement compared to 94.5% registered in 2014. In turn, this high level of debt has negative long term effects on growth. During the three crucial years from 2011 to 2013 the Eurozone pursued a fiscal tightening that caused a severe drag on economic growth and thus it nullified the intended goal of reducing public debt burdens. One important reason why the consequences of austerity were severe was that European economies are heavily engaged in trade with each other; hence, as any one country slowed down, its weaker import demand hurt growth elsewhere (Mody, 2015). Furthermore, debt ratios in the Eurozone have tended to increase due to the pro-cyclical effect of budget consolidation (Manasse, 2015).

As Eichengreen and Panizza (2014) argued, the 60% level targeted in the EU's Fiscal Compact by 2030 is too ambitious for the most indebted countries in the Eurozone, and it is a very difficult goal to achieve. In fact, these countries should run a very large surplus, since the heavier the debt, the higher the interest rate, the slower the growth rate and the greater the surplus needed[32]. Thus, there are still concerns about the sustainability of public debts (especially in Greece, but also in Italy). In addition, the deflation that the Eurozone has been experiencing since 2014 is not helping to lighten the debt burden, while real growth is weak and may even be slowing in the near future. This is why the ECB decided to start a QE programme in January 2015. This decision has contributed strongly to lower yields on sovereign debt, but despite this record of low interest rates, Eurozone continues to struggle with a severe debt problem. Even with asset sales and supply reforms implemented by several governments, it is still an enormous challenge. As Dyson explained (2014, p. 408), the treatment of debt by the Eurozone countries was a hybrid solution. It was the combination of the euro-denominated debt issuance by the member states with the failure to create an institutional arrangement in the Eurozone for joint liability (i.e. Eurobonds). At the same time, cross-border debt assumed a hybrid character once the European Central Bank evolved into lender-of-last resort to the banking sector, once it agreed to undertake unlimited interventions in the secondary sovereign bond markets (although on strict conditions)[33], and once the European Stability Mechanism (ESM) was established to provide collective financial assistance, including intervention in the sovereign bond market.

[31] Also non-financial corporate debt exceeds 100 percent of GDP in many countries (e.g. Belgium, Finland, France, Ireland, Portugal, and Spain).

[32] The average primary surplus in the decade 2020-2030 should be around 5.6% for Ireland, 6.6% for Italy, 5.9% for Portugal, 4.0% for Spain, and 7.2% for Greece.

[33] As was the case of OMT. Also the QE has influenced the sovereign bond markets and has tended to recast the ECB as lender of last resort.

6. The Eurozone needs a new strategy

The strategy followed by the European authorities during the deep and prolonged crisis was a *status quo* strategy. The proposals contained in the report of the five presidents has been an insufficient response and within the vision of ordoliberalism. Although structural reforms to improve competitiveness are important, major emphasis should be given to innovation, improvement in human capital, innovative and growth-promoting investment. European authorities should pursue a forward-looking economic policy that creates more opportunity for the young, reduces inequalities in income and wealth, and should have a clear and effective plan for the refugees and economic immigrants without forgetting the constraints of security, in order to counter Europe's secular trend towards stagnation. At present, Brussels is softening austerity constraints with a more flexible Stability and Growth Pact and with the precise aim of contrasting pro-cyclical policies and favouring investment, leaving some individual countries (e.g. Italy, France, Greece, Portugal and Spain) space to boost their economies, while Draghi is extending and expanding the QE programme. But imbalances within the Eurozone are still present, especially with regard to the indicators of the real economy, namely debt and current accounts, unemployment rates, poverty levels. In addition slow economic growth and low inflation are gripping the Eurozone, and the problem of Greece is still on the spotlight. Thus the economic crisis is not really over. Several economists (e.g. Chopra, 2014; Posen, Ubide, 2014), suggested an expansionary aggregate demand and to relax fiscal constraints for investment with the aim of enhancing productivity and growth. However, the ideology of ordoliberalism with its economic policy implications is still powerful, and the austerity policy is backed by many supporters (e.g. Germany and other countries). Public opinion is experiencing a growing intolerance regarding the Eurozone because of its painful reforms at the expense of safety and safeguards. Furthermore, nationalistic tendencies and dissatisfaction towards Europe, its rules and its policies are leading to a growing rift between the EU countries, a detachment that might have unpredictable political consequences regarding the survival of EMU. Also, a negative opinion of the unifying Schengen treaty, which is seen today as the open door that feeds the migration processes, is another signal of this trend toward disconnection. But Europe with the Schengen treaty and the single currency in the background looks like the Europe of the single market. The EU referendum in UK in June 2016 that led to Brexit is a clear signal of distrust towards the European institutions. The result is politically very significant, not to mention the economic consequences. There could be another possible strategy. This consists in the rewriting of treaties to guide institutions and practices towards a confederal model determining fewer competences and powers reserved for the centre (Brussels), whilst all the rest remains in the power of member states, without any fundamental renunciation of internal sovereignty. Of course, this last strategy involves re-designing the powers of the institutions and also removing several prerogatives of the European Commission and the European Parliament.

In this chapter we have described and discussed the new institutional framework of the EMU which has been established to react to the crisis and which is still in progress. A key point of the new EMU is the banking union, since the crisis had finance and financial markets at the center stage. But the banking union must rest not only on the SSM and the SRM, but also on the European Deposit Insurance Scheme (EDIS), which is still not in force. Although among the member countries there is awareness of the need to move towards a risk-sharing, the divergent interests among them and the fear of failure to reduce such risks are still prevailing. In any case the EDIS must be embedded in a global context, not just regional (the Eurozone), since financial markets are global and interconnected. Financial stability needs appropriate monetary and fiscal policies and the correct institutional design, therefore a complete banking union would require that the ECB's lender of last resort role for banks should remain a regular feature of EMU, and thereby enhance its resilience (Obstfeld, 2013; Schilirò, 2014). Moreover, the banking union would require at least some centralized fiscal capacity (Pisani-Ferri, Wolff, 2012; Obstfeld, 2013). But such centralized fiscal capacity may be guaranteed only with an independent taxation capacity. Therefore, fiscal union becomes a necessity to obtain a complete banking union and improve the functioning of the EMU (Obstfeld, 2013; Véron, 2014; Mody, 2015). Obstfeld (2013), however, points out that the necessary fiscal aspect raises essential questions about the democratic accountability of the decision makers who run it. Nicholas Kaldor (1978) had already warned against a monetary union without a political union. He argued (1978, p.205) that "the objective of a full monetary and economic union is unattainable without a political union; and the latter pre-supposes fiscal *integration*, and not just fiscal *harmonisation.* It requires the creation of a Community Government and Parliament which takes over the responsibility for at least the major part of the expenditure now provided by national governments and finances it by taxes raised at uniform rates throughout the Community". Fiscal union would imply a single budget, a new role for the European Parliament and the other European institutions, a common deposit insurance system, the Eurobonds, more financial risk-sharing, a common unemployment benefit system, and fiscal rules based on simple and transparent indicators. There are several proposals on fiscal union. For instance, Sapir and Wolff (2012, 2015) recommend a coordination of fiscal policy. Their proposal involve an important role for ESM and the necessity to change the treaties. It is not a true fiscal union, but essentially a fiscal mechanism to ensure that shocks are met by the union as a whole[34]. The debt problem is also related to fiscal policy and, in this respect, the Eurobonds, i.e. jointly issued bonds to lower funding costs, become a strategic tool of a reformed strategy. Since the start of the euro crisis, there have been several proposals to implement the Eurobonds (e.g. Depla, Von Weizsäcker, 2010, Obstfeld, 2013, Tonveronachi, 2015). But fiscal union and greater economic and political integration are problematic goals to achieve at present, given the new surge of nationalism. The European institutions and the powerful bureaucracy behind them must understand that the full mandate they have enjoyed for decades from European citizens must end. The technical and depoliticized approach followed by European elites committed to governing the European Union and the Eurozone from the top is no longer viable, because the citizens of the member states are seeking a political debate and real influence on key issues of the economy and policy. The "hot issues" to reshape a more accomplished EMU remain: the pooling of resources, the sharing of risks, the simplification and transparency of rules, a fiscal policy organized and managed at Eurozone level, a greater homogeneity of legislations among the member countries in the various economic fields, a certain degree of flexibility in the policies and last, but not least, political legitimacy. Finally, it would be better to have a single currency adopted by all UE countries. This will make the Eurozone stronger and will help to overcome some institutional problems related to the EU/Eurozone relationship[35]. Nevertheless, most of the proposals would require changes in the European treaties, since the Eurozone needs to continue reforming its architecture. But what is more important is the need for a new political pact that gives democratic legitimacy, transparency and accountability to the European institutions and that can

[34] For details Sapir, Wolff (2015, pp.6-7).
[35] Schilirò (2014).

allow a new long term strategy based on principles such as cooperation, innovation, solidarity and social inclusion.

Conclusions

This paper has examined the rules and the policies of EMU during the crisis, stressing limits and flaws of the institutional architecture. Imbalances and divergences, which are present within the Eurozone, have been also analyzed with a focus on current account balances, growth and the debt problem across member countries. Furthermore, the evolution of governance in the Eurozone and the definition of a new institutional framework have been discussed. Lastly, an attempt has been made to outline a new strategy that the Eurozone should follow in order to be able to guarantee stability, cohesion and development.
Since the onset of EMU, the European authorities have followed a method that has proven to be unsatisfactory in dealing with urgent problems. They have found temporary and partial solutions, with the aim of keeping the *status quo*. In this spirit, the European and Eurozone authorities have organized three very costly bailouts of Greece, avoiding the cancellation of the Greek debt, and leaving the country in a deep recession. In addition, their policies have not been able to spur growth across the Eurozone (except Ireland) and to get it out of the trap of deflation. The new strategy, instead, must involve increased coordination among the European institutions and more flexibility in the policies and in the rules that constrain them. But, more importantly, a new political approach between the citizens of the member states and the European institution is needed. Brussels is facing growing Euroskepticism from many of its member states, including *a fortiori* the U.K., which has voted to leave the European union. The citizens of the EU nowadays seem convinced that the Union is intended to represent something less than the sum of its parts. European people are questioning the serious lack of public representation or institutional responsibility in Brussels. The problem of democratic legitimacy is a central issue for the future of the Eurozone. Any step towards a fiscal union, which is inevitably linked to the accomplishment of a complete banking union, poses the basic question of the concept of 'no taxation without representation'. All this calls for relevant changes in the institutional framework, including the European treaties. Without this new strategy and new political pact, the Eurozone will continue to faithfully observe rigid rules, but it will slip into a decline of no return and become a union without power and political relevance.

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