Financial Markets and Debt Crisis in European Union: Preventing spillover effects of financial crisis between EU periphery and the eurozone

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11 December 2016

FINANCIAL MARKETS AND DEBT CRISIS IN EUROPEAN UNION:

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Preliminary version, March, 2017, do not quote without the authors' explicit consent

Abstract

When the financial crisis revealed weaknesses in eurozone governance, EU responded with new prevention and crisis resolution governance structure and counter-cyclical policies. A new surveillance procedure for the prevention and correction of macroeconomic imbalances, the so called Macroeconomic Imbalance Procedure (MIP). The EC has recognized the existence of excessive imbalances that requires strong and comprehensive policy measures to undertake significant adjustments. International competitiveness indicators and policy instruments are the most important for correction of external imbalances. This is also one of the major challenges in the euro zone – the symmetric adjustment of the intra – euro area competitiveness divergences and external imbalances. For non – euro area EU members, monetary strategies and exchange rate policies are highly important instruments of adjustment process. Spillover effects of financial crisis in EU periphery (non – EMU economies) could be damaging for the eurozone economies. The European economic governance mechanisms are inconsistent with specific position of the non - euro area countries of the EU. The aim of this policy paper is to analyze European economic governance for non – euro area members. Our reform proposals are based on the two basic areas of improvements in European economic governance for non – EMU members of the EU: (a) new approach to the European Semester, and (b) new financial assistance facilities for non – euro area countries, in order to reduce contagion risk in EU.

Key words: European Union debt crisis**,** European economic governance, EU conditionality, European Semester, spill – over effects, external adjustment mechanisms, crisis mechanisms for non – EMU economies, Brexit, Italy's banking crisis, ECB, Target 2

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JEL classification: B50, E60, E61, F30, F33, F36, F42, H12

Introduction

Non – area members of the European Union has full monetary independence, but large capital inflows and excessive credit expansion, accompanied with capital market deregulation, in the period 2000 – 2008 led to unstable economic structures and inherent financial instability, according to Hyman Minsky's theory of financial cycles. Unstable economies are fragile to various external shocks, such as sudden stop or credit crunch on international capital markets, increasing contagion risk within EU, such as Brexit and Italy's banking problem, but this instability is also the main cause of cross – border banks' deleveraging. Banks' deleveraging had put additional deflationary pressures on national economies, deepening financial crisis and recession and limiting policy options for counter-cyclical strategies.

(1) European Semester and non – EMU countries

Following the euro zone crisis, financial stability in EU periphery becomes an issue of concern, in particular when banking crisis in Italy got momentum (see, for instance, Veron, 2016). Pre-crisis reliance of huge capital inflows and accumulated external debt created a systemic risk in non-euro area of European Union as well in weak economies of EMU area (Torbjorn et al, 2010). Euro zone area members were hit by systemic debt crisis. When the financial crisis revealed weaknesses in EMU governance, EU responded in December 2011 with new prevention and crisis resolution governance structure and counter-cyclical policies, so called Six Packs: A new surveillance procedure for the prevention and correction of macroeconomic imbalances, the so called Macroeconomic Imbalance Procedure built around two-step approach. The first step is an alert mechanism consisting in a scoreboard with early warning indicators put in place by the European Commission to focus on risks; in a second step, a more in- depth analysis (EC, 2016) is undertaken in those countries identifies in Alert Mechanism Report (AMR). The MIP scorecard consists of eleven indicators and indicative thresholds, that are signaling device of emergence of macroeconomic imbalances in early stages (see e.g., European Commission, 2016, for MIP methodology). Therefore, major adjustments still lies ahead, while fiscal consolidation and wage deflation policy during the cycle downturn could aggravate prolonged recession. This is also one of the major challenges in the euro zone – the symmetric adjustment of the intra – euro area competitiveness divergences and external imbalances (on flaws in EC policy recommendations within the European Semester framework and reform proposals of the European Semester, see e.g. Darvas and Vihriala, 2013; Sapir and Wolf, 2015, Juncker et al, 2015). For non – euro area EU members, monetary strategies and exchange rate regimes are highly important instruments of adjustment policies.

1.1. New Approach to the European Semester and MIP for non – EMU countries

We have to look closely at the origins of euro zone crisis. There are several important research papers analyzing comparatively euro zone, in particular peripheral countries and emerging market crises. In all cases there was similar macroeconomic cyclical dynamics, which is clearly related to the inherent financial instability theory of Hyman Minsky. A key element of this cyclical pattern in endogenous behavior of agents' risk perception and expectations. It was clearly boom – bust Minskyan cycle, which started with asset price inflation supported with the financial expansion, leading to increasing fragility of the economy. But, in burst phase, when asset bubbles deflate, there was sharp disinflation dynamics with deflationary pressures and agents are forced to assume wealth losses. The development of the bust cycle leads to systemic crisis. But, according to such analytical approach (for instance, see more in: Frenkel, 2013) EU periphery crisis reveals stylized facts: (1) in the booming phase there were changes in macroeconomic policies, which typically included the liberalization of the capital account of the balance of payments and introduction of some sort of fixed exchange rate system. (2) there was deregulation of capital markets and financial industry, leading to credit expansion; (3) international capital movements played a crucial role in the boom and contracting phase, in boom phase there were large capital inflows, while in the contraction phase, there were significant capital outflows and deleveraging of the cross – border banking groups, leading to credit crunch and financial disintermediation. These three elements gave rise to cyclical dynamics that has certain consequences: rise of asset price inflation, while core inflation was under control; expansion of credits into non – tradable sector, due to capital inflow and real appreciated exchange rates, causing fragile economic and financial structures, which are prone to financial crisis (sudden stop; deflation; exchange risk, contagion and sovereign risks). Current account was in deficit, foreign debt was accumulated leading to unsustainable levels of external imbalances. Beyond this common styled facts, there was different path between core and periphery of the EU, and between euro area and non – EMU economies. In the case of EU, policy response was based on „expansionary fiscal contraction" hypothesis, with negative feedback mechanisms that lead EU economies in distress to debt deflation and low international competitiveness. Comparative economic studies leads to a specific conclusion (Frenkel, 2013; Radosevic and Cvijanovic, 2015) that countries affected by the Mynskian cycles should: (1) adopt flexible exchange regimes to provide flexibility to policymakers; (2) introduce capital controls at a market based manner, regulating capital flows, and (3) implement balance-of-payments policies that could ensure external equilibrium, such as preservation of competitive real exchange rates and accumulation of central bank FX reserves (initial level could be accumulated in accordance with Guidotti – Greenspan ratio). This is the rationale behind our approach to reform of European economic governance, in particular economic governance for non – EMU member countries.

After crisis started in 2008, there was intense debate about currency devaluation versus internal devaluation. There are several key differences between two options (see e.g., Becker et al, (2010) for the main differences between two approaches to external adjustments), i.e.: (1) timing, since currency devaluation is immediate, while internal devaluation takes a long time; (2) magnitude of adjustment, since currency devaluation could lead to overshooting, while internal devaluation may not bring adequate adjustment. Internal devaluation, i.e. price and wage cuts, may not be sufficient enough, and adjustment in the private sector will not restore international competitiveness, but, at the same time, unemployment rate could be so huge and rapidly increasing, (3) because labor market adjustment will mainly be felt through job losses, rather than through changes to the average wage. In summary, internal devaluations could prove to be unsuccessful, causing job losses and without significant contribution to international competitiveness. External adjustment, could be a consequence of demand contraction, not wage cuts, and after recession external imbalances could build – up again as well increase in foreign debt. On the whole, flexible exchange rates proved to be better shock absorbers. We agree with policy approach that emphasizes the choice of exchange rate arrangement as one of the key strategic options in countries that are at the path to European monetary union. The choice of exchange rate regime is especially important when capital flows are liberalized, financial sector deregulated and central bank supervision is weak. Maastricht criteria, Stability and Growth Pact (SGP) and Fiscal Compact rules underestimated the importance of external disequilibrium, and this is the main reason why the signaling role of the current account deficit was not implemented as policy instrument. Our European economic governance reform proposals are based on evidence of the significant role of exchange rate policy in the growth process, that is crucial for non – EMU economies. The relative price of tradables to non – tradables (the real exchange rate) seems to play more fundamental role in the growth process, in particular for developing economies. Namely, avoiding appreciating currency is the most challenging issue for policymakers in countries with macroeconomic imbalances, although it was unavoidable consequence of liberalized capital flows in the boom phase of economic cycle. Real exchange rate is a very important policy variable, while exchange rate policy have significant effects on current account balance of the balance-of-payments and economic growth respectively. Thus, in order to strengthen economic governance, a first reform of the EU law provisions on the coordination of member states' economic and budgetary policies was introduced with the approval of the European Semester in September 2010, when excessive macroeconomic imbalances were accumulated, and established as divergences in current account balances of the balance-of-payments between core and periphery of the EU. New rules included provisions on sustainable external imbalances, such as current account deficits/surpluses (as a percentage of GDP) and capital account balances (NIIP as a percentage of GDP). This is the most important pillar of Macroeconomic Imbalance Procedure, but MIP is now effective only as a corrective arm, because the preventive policy instruments in EU coordination mechanisms failed (on the significant reform that have been adopted at the euro area level since 2010, see more in: Juncker et al., 2015).

1.2. Dollarization and Financial Instability in EU Periphery

There is consensus among monetary economists that partial or widespread dollarization (in non euro area economies this is basically „euroization“) can magnify a country's vulnerabilities, which relates to balance-of-payments, the banking sector and its borrowers and also fiscal sustainability. In summary, dollarization may increase the macro/financial vulnerabilities of a country already prone to exogenous shocks or misguided policies, dollarization is in the root of excessive macroeconomic imbalances. In a non – EMU member countries, in particular in postcommunist and transition countries there are several forms of dollarization (more on dollarization and de-dollarization policy options, see in: Armas, Ize and Levy Yeyati, 2006). The most important are „liability dollarization“, where banks have liabilities to savers in the form of foreign currency deposits (FCDs); and „asset dollarization“, whereby banks have extended credit to residents (including government) in foreign currency. Dollarization not only increase the vulnerability of financial systems to currency and contagion risks, but also limits the flexibility of the exchange – rate policy in external adjustment process, what is more important for the non – EMU transition economies (for instance, in Croatia there is very high level of asset and liability dollarization, which has blocked flexibility necessary for countercyclical economic policies, see more in: Radosevic and Vidakovic, 2014b), because of negative balance- sheet effects on various sectors of national economies (see e.g., Goldstein and Turner, 2004). This means dealing with seriously misaligned exchange rates. Counter-cyclical policies in EU countries have to be twofold: euro area countries have to cope with internal devaluation, i.e. price and wage cuts, because they has not independent monetary policy, as a full members of euro zone. Non – EMU economies could make external adjustment with reflationary counter-cyclical monetary policy (external devaluation) because they still have an independent monetary policy and social costs of such monetary strategies are much lower. National macroeconomic policies and exchange rate policy – and the incentives linked to them – matter a great deal for generating dollarization and managing currency mismatches, and significant progress has to be made in reducing the level of dollarization over the medium term. It is evident that primary responsibility for controlling dollarization resides at the national level (in non – EMU economies of the EU), but external conditionality by the EU could help by monitoring and by making reduction of those dollarization over the medium term a condition for EU financial assistance, and even for IMF loans. This is why we suggest reform proposals that agenda for reducing the dollarization should be a quantitative criterion in Excessive Macroenomic Imbalances Procedure and significant element of structural conditionality of the EU within the context of European Semester.

1.3. Selective approach with targeted policy instruments within the context of the European Semester

In summary, there are several components of an new (Excessive) Macroeconomic Imbalance Procedure within the context of the European Semester, that should be adjusted for non – EMU economies and for prevention of contagion and systemic risks in an integrated EU capital market:

- A rule for real exchange rate (based in HIPC deflator) that is close to equilibrium real exchange rate, in order to prevent syndrome of currency misalignment (Dutch disease);

- A rule for ensuring the flexibility of exchange rate policy for non – euro area countries (internal devaluation rule could not be applied for non – EMU economies as a rule, if there is possibility for using monetary independence; however, it can be applied as an exception on the basis of the Social Compact in the member country, while it is the only policy option for euro area countries);

- A rule for systemic financial stability (NPLs and currency mismatch) aiming to secure systemic stability and flexibility of monetary policy instruments, as precondition for transitional monetary arrangements for non – EMU economies on the long – term path to euro adoption;

- A rule for asymmetric inflation target, securing price – level targeting with explicit optimal inflation target (as a precondition for „nominal GDP targeting" or/and "price – level targeting" monetary strategy), and prevention of non – EMU country to slide from low inflation into the outright deflation, and then into deflationary spiral and liquidity trap (monetary stability quantitative criterion).

In accordance with the new selective and targeted approach of the Macroeconomic Imbalance Procedure for non – euro area member countries, the new scoreboard consists of the following indicators and indicative thresholds, which are aiming to cope with competitiveness crisis:

External imbalances and international competitiveness

- three - year average of the current account balance in percent of GDP, with indicative thresholds of + 6 % of GDP and - 4 % of GDP;

- net international investment position (NIIP) in percentage of GDP, with an indicative threshold of – 35 % of GDP, the NIP shows the difference between country's external financial assets and its external financial liabilities;

- five - years percentage change of export market shares measured in values, with an indicative threshold of – 6 %;

- three – years percentage change in nominal unit labor cost (ULC), with an indicative threshold of + 9 % for euro countries, only;

- three – year percentage change of the real effective exchange rate (REER) based on HICP deflators, relative to 3 major trading partners, with an indicative thresholds of +/- 5 % for euro – area countries, only;

Internal imbalances and monetary stability

- private sector debt (consolidated) in percent of GDP, with an indicative threshold of 133 %;

- private sector credit flow as a percentage of GDP, with an indicative threshold of 15 %;

- year – on year changes in inflation rate based on HICP deflators, with an asymmetric target for inflation rate of „close, but below 2 %“ and an indicative treshold of 0,5 % for deflation rate, for euro and non – euro area countries, respectively;

- year – on – year changes in deflated house prices, with an indicative threshold of 6 %;

- public sector debt in percentage of GDP, with an indicative threshold of 60 %;

- three – year average of the unemployment rate, with an indicative threshold of 10 %;

- year – on – year percentage change in total financial liabilities of the financial sector, with an indicative threshold of 16, 5 %,

- year – on – year percentage change in total non – performing loans (NPLs) in total loans of the financial sector, with an indicative threshold of 15 %, for euro and non – euro area countries, respectively;

- year – on year percentage change of currency mismatch (euroization) in percentage of the total asset and liabilities of the financial sector; with an indicative threshold of 35 % for non euro – area countries, only.

These elements of new methodology for macroeconomic imbalances assessment (see, EC, 2016) are needed for the purposes of correction of macroeconomic imbalances. The scoreboard for identification of macroeconomic imbalances within Alert Mechanism Report (see more, in EC, 2015a) as a mechanism for screening and in – depth analysis of imbalances is not a static tool and already number of changes has been implemented. Regular assessments of the scoreboard variables continue to be necessary in order to capture macroeconomic developments and statistical progress, as it was concluded by the European Commission (see in more details in economic governance report by the EC, 2014b). Consequently, our reform proposals are fully consistent with such views of the European Commission and could contribute significantly to inherent flexibility of Macroeconomic Imbalances Procedure framework. Close monitoring of policy implementation that is specific for non – EMU member countries is final result of our reform proposals and it is in line with outcome – based conditionality of the European Union.

(2) Flexibility of Macroeconomic Adjustment and European Semester

2.1. Fiscal Compact Flexibility

EU Council has compiled a new Fiscal Compact Treaty on 9 December 2011. Many economists think that Fiscal Compact in fact contains budgetary constraints enshrining ‘pro-cyclical fiscal policies’ and even outlaw Keynesianism. But, if a Eurozone has a large output gap, it can implement a fiscal stimulus to reduce it. Also, in January 2015 EC has issued a new fiscal flexibility guidelines (EC, 2015). The guidelines cover three issues: (1) the structural reform clause, (2) the investment clause and (3) the cyclical conditions. Therefore, new flexibility rules of the Fiscal Compact are consistent with counter – cyclical policies.

2.2. Unconventional Monetary Policy Options in Non – Euro Area Economies of the EU

The aim of the policy makers in EU should be to determine the policy options for non – standard monetary policy measures in non – EMU economies that are peripheral countries of the EU.

Over the course of the last six years there have been three key macroeconomic developments: (a) EMU and non – EMU economies are in recession, i.e. stagdeflation (stagnation and deflation) or, better to say, "secular stagnation" – the persistent underuse of potential resources. (b) Banking industry is stable, but NPL are increasingly adding to the inherent financial instability (high public and unsustainable external debt, with currency mismatch in all sectors of national economies in non – EMU economies), and (c) recessionary dynamics and capital outflows (banks deleveraging) are contributing to sharp disinflation that is now transformed into deflationary pressures in Europe. Wage deflation was the main policy instrument after the crisis started. Deflation risk in EU and EMU was very high in 2015 & 2016 and beyond, and economic policy decision makers do not fully understand the severe negative effects of persistent and too low inflation rate. Also, since the start of recession, banking sector has been extremely liquid, but accompanied with the credit crunch and deleveraging due to the balance-sheet recession. There are, in addition to balance – sheet recession, also, key elements of paradox-of-thrift recession (aggregate demand and private consumption are contracting, while there is an increase in banks' savings deposits by the households). High liquidity in financial system was not intermediated by the financial/banking institutions into credit activity to SMEs and corporate sector of economy (transmission mechanism failed). There are complex questions that has to be answered: how can unconventional monetary policy could be implemented in limiting adverse effects of financial instability on the monetary transmission mechanism and how to achieve the effectiveness of (targeted) monetary policy measures, as well the interaction between the non-standard policy measures and new central bank macroprudential strategies, within the framework of EU Banking Union (SSM and SRM)? Absence of credible and efficient macroprudential policies (for instance, dynamic provisioning targeted to curb the growth of particular groups of loans, such as foreign – exchange denominated loans, particularly important issue in non – EMU economies) resulted in a fragile domestic financial systems.

Macroeconomic imbalances in non – euro area have to be addressed with comprehensive reforms, starting with external macroeconomic imbalances (the main issue is international competitiveness), in coordination of central bank and governments. In a nutshell, there are three main areas of concern: (1) Institutional arrangements of central banks, objectives and monetary policy strategy: what kind of monetary policy strategies in non – EMU economies can they implement in the "transitional period" between membership of the EU and EMU (new type of

ERM – 2 arrangement and MIP procedures are needed for new entrants to monetary union)? (2) Monetary policy instruments: the effectiveness of non-standard policy measures in deflationary crisis or/and persistent low inflation environment (noflation or lowflation) in open economies at the periphery of the EU? How is possible to increase flexibility of pegged exchange rate regime, without adverse effects on balance-sheets, but improving external competitiveness and exports? (3) Monetary policy and macroprudential strategy: the interaction between the implementation of unconventional monetary policy measures and new macroprudential strategy of the central bank? Asset Quality Review (AQR), applying ECB methodology has to be continued and we are in favor of non – EMU economies membership in EU Banking Union, in particular SSM aiming to break the dysfunctional ties between national regulators and domestic financial institutions, in order to prevent "regulatory capture". AQR should indicate the real need for bail-in and bail-out arrangements within SRM. Our conclusion is that non – euro area economies of EU periphery (for instance, Croatia, Bulgaria, etc.) has limited options for unconventional monetary policy strategies, while industrial economies (for instance, United Kingdom, Denmark, Sweden) already started with QE as a counter – cyclical monetary strategies.

(3) EU Conditionality

Conditionality was introduced by the EU institutions and basic element of European economic governance only after 2010 and it was based on IMF conditionality practice. EU conditionality secures certain level of flexibility, in particular under MIP procedure implementation and certain provisions of Fiscal Compact, but EU conditionality could be augmented with additional structural measures for non – euro area EU members (de-euroization, enhancing greater exchange rate flexibility and review - based monetary conditionality framework as an option for countries with evolving monetary policy regimes). But, macroeconomic conditionality has to be related to EU/EMU policy coordination mechanisms, that are introduced by the Stability and Growth Pact and its revisions (excessive deficit procedure), as well by the Six pack and other instruments of policy coordination and crisis management (ESM, EU banking union, balance of payments assistance, etc.). What is the current status of EU conditionality in terms of economic policy coordination (see more, in: Ioannidis, 2014)? We suggest that EU could make changes in institutional framework for new structural conditionality (SC). New structural conditions, together with new traditional (quantitative) conditionality, as signaling preventive device of the EU, could be focused on policies that were intended to correct distortions in relative prices and seeking a lasting solutions to macroeconomic problems, including measures aiming to prevent the emergence or control of macro/financial vulnerabilities in EU member countries. Thus, EU could focus on the promotion of SC to the promotion of structural reforms in EU members (catalytic role of conditionality in reforms). Our proposals for the new design of EU conditionality (i.e. for the design of new MIP framework) include: (1) introducing new components and flexibility in timing of structural conditionality to promote reforms; (2) streamlining structural conditionality to prevent external and macro/financial vulnerabilities, in particular in non – euro area countries; (3) application of "outcome – based" conditionality; (4) introducing flexibility in EU financial assistance facilities for non – euro area countries, financial assistance mechanisms with ex – post conditionality, similar to the Target – 2 mechanism for euro area countries.

(4) New Financial Assistance Facilities for non – euro area countries

Balance-of-payments crises within EU and EMU could be triggered for various reasons: macroeconomic imbalances, external and/or internal imbalances; financial crises, triggered with the bank runs after asset bubbles bursts; deflationary crises, credit crunch and rapid deleveraging process accompanied with sudden stop, capital flight and inappropriate exchange rate targets, etc. During financial crisis in the eurozone, relatively little attention has been paid to a specific rescue mechanisms that are older than euro – area crisis mechanism, because they were designed prior to euro introduction and establishment of the ECB.

4.1. Balance-of-Payments financial assistance mechanisms for non – EMU members

It is the Balance-of-Payments- Facility (BoPF), medium – term financial assistance mechanism for non – euro member states that face difficulties accessing international financial markets to satisfy debt obligations denominated in foreign currency and maintain stable exchange rates (EC, 2014a). Today there are only nine non-EMU states that are eligible for financial assistance (Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Poland, Romania, Sweden and United

Kingdom). Six countries have not determined yet when they will join the European Monetary Union, but they accepted their obligation to do after transition period, when nominal and real convergence has to be successfully achieved (Bulgaria, Croatia, Czech Republic, Hungary, Poland and Romania). United Kingdom and Denmark made official Opt-out, although Brexit means complete exit from EU obligations, while Sweden claimed Opt-out. Currently, there is a discussion on whether the instruments of the BoPF may be insufficient for future crises. EC has put legislative proposals (see more in: Heinen, 2014b and Radosevic, 2014a) to align the BoPF with ESM mechanisms and recent changes to the Stability and Growth Pact (SGP), so called Six-pack and Two-pack reforms. There are three areas of BOPF improvements: (1) existing loan instruments of the BOPF should be complemented with credit lines; (2) facility should be aligned with the recently established economic surveillance framework and economic policy coordination mechanisms of the EU; (3) the process of BoPF approval was linked with EU conditionality, because loan approval was made conditional upon so called Macroeconomic Adjustment Programme, which comprises the terms and conditions of economic conditionality. It is beyond the scope of our research to analyze in more details proposed changes of BoPF. But, as we can see it, there is ongoing discussion on flexibility of BOPF instrument and economic conditionality, which has to be integrated within EU policy coordination and crisis resolution mechanisms.

4.2. Standing swap arrangements between the ECB and national central banks of non – euro area countries in EU

This is the reason why we suggest that EU could think about more efficient balance-of-payments financial assistance mechanisms for non – EMU members, such as standing swap arrangements between ECB and national central banks of the non – euro area member countries of the EU. Since the onset of the financial crisis in 2007, bilateral central bank swap lines allowing the provision of foreign currency to local counterparties have become an important tool of central bank international cooperation to prevent systemic risk and limit contagion risk. Central banks of non – euro area member countries are integrated into Eurosystem of national central banks of EU economies, although with limited cooperation between ECB and national central banks. Since the start of the financial crisis, the ECB concluded a number of agreements within the context of systemic crises in Latvia and Hungary. Liquidity – providing swap lines between central banks enable the receiving national central bank to obtain foreign currency and redistribute it locally to its counterparties unconstrained by the levels of its foreign exchange reserves. This is crucial for the non – euro area member countries, because they do not have access to Target -2 credit lines (see, Higgins and Klitgaard, 2014). For the ECB, these arrangements represent a monetary policy instruments in which risks are shared at the Eurosystem level and decision – making process for monetary policy applies. We suggest that as a precautionary measure, the ECB could establish a network of standing bilateral swap lines with national central banks of non – EMU economies as an instrument to containing contagion and reducing systemic risk and spillover effects on euro area markets.

(5) Conclusion and Recommendations

Reform of the European economic governance is held back by disagreement on what is the root of economic crisis in euro area? Euro area suffered excessive macroeconomic imbalances, that are consistent with Mynskian cycles, because in pre – crisis period there was insufficient focus on current account deficits, dualism between „core“ and „peripheral“ Europe, price and wage divergences, leading to competitiveness crisis and building – up financial imbalances and there was a lack of attention of policy makers in EU at inherent financial instability, systemic risk and they underestimated contagion risk, while there were not in place until 2010 appropriate coordination and crisis resolution mechanisms in EU and EMU. Peripheral euro area and non – EMU countries were particularly prone to crisis, due to their unstable economies and boom – bust cycles that were supported with procyclical policies. There is high risk of spillover and financial contagion in Euroepan Union (Rigobon, 2016), in particular within the context of banking crisis in Italy (Veron, 2016; and Sinn, 2016). Major weakness of euro area governance was that it lacked a mechanism to monitor and correct macroeconomic imbalances, except in budgetary policy, external debt and current account imbalances were all but ignored (Sapir and Wolff, 2015). Reform of this governance in needed in three major areas, but in our research we were focused on European economic governance for non – EMU member countries, as follows: (1) new selective Macroeconomic Imbalance Procedure approach, addressing the international competitiveness and financial (in)stability issues; (2) introduction of more flexibility in fiscal and monetary policies; and, (3) new liquidity facilities for emergency balance-of-payments purposes, as a precautionary policy instruments of the EU and ECB, reducing thus cross – border contagion risk in EU.

Our proposals for the improvements of EU conditionality (new MIP framework) include: (1) introducing new components and flexibility in timing of structural conditionality to promote reforms; (2) streamlining structural conditionality to prevent external and macro/financial vulnerabilities, in particular in non – euro area countries; (3) application of “outcome – based” conditionality; (4) introducing flexibility in EU financial assistance facilities for non – euro area countries, financial assistance mechanisms with ex – post conditionality. EU could introduce institutional framework for new structural conditionality (SC), very similar to structural conditionality at the IMF. New structural conditions, together with new traditional quantitative conditionality (as signaling device) of the EU, could be focused on policies that were intended to correct distortions in relative prices and seeking a lasting solutions to macroeconomic problems, including measures aiming to prevent the emergence of macro/financial vulnerabilities in EU member countries. Thus, we could focus on the promotion of SC to the promotion of structural reforms in EU members (catalytic role of conditionality in reforms). And, last but not the least, we suggest that „traditional“ EU conditionality (within existing EU economic surveillance framework and MIP procedure) should include monetary policy framework conditionality, based on the principles similar to the IMF monetary policy conditionality, because non – EMU members have greater flexibility for external adjustment (exchange rate policy as policy instrument for improving international competitiveness) in comparison with EMU members of the EU. There are several components of an new (Excessive) Macroeconomic Imbalance Procedure within the context of the European Semester, that is adjusted for non – EMU economies and for the prevention of contagion and systemic risks in an integrated EU capital market: (1) a rule for real exchange rate (based in HIPC deflator) that is close to equilibrium real exchange rate, in order to prevent currency misalignment (Dutch disease); (2) a rule for ensuring the flexibility of exchange rate policy for non – euro area countries; (3) a rule for systemic financial stability (NPLs and currency mismatch) aiming to secure systemic stability and flexibility of monetary policy instruments, as preconditions for transitional monetary arrangements for non – EMU economies on the long – term path to euro adoption; and, (4) a rule for asymmetric inflation target, securing price – level targeting with explicit optimal inflation target (quantitative criterion for monetary stability). A reformed European Semester with more flexibility, better timing and increasing national ownership of reform programmes could lead to a better dealing with macroeconomic imbalances in EU.

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