

AUSTERITY

To my father, Bino

**AUSTERITY
EUROPEAN DEMOCRACIES
AGAINST THE WALL**

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**CENTRE FOR EUROPEAN POLICY STUDIES (CEPS)
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INTRODUCTION

Ten years after the introduction of the euro, a crisis engulfed Europe, a crisis that put at risk the survival of the single currency and the European Union itself. Despite steps taken to strengthen EU institutions, numerous European summits and interventions by the governments and the European Central Bank, the crisis has not been resolved. It will take years before it is fully overcome.

The crisis has had dramatic effects on Europe's economic and social fabric. This is evident in the rising unemployment (above all among youth), the increase in poverty and the decline in family income, which in some countries has dropped to the levels they were 20 years ago. All this has put at risk the well-being achieved since the end of the Second World War.

The economic aspect, while serious, is only the symptom of a larger problem. The crisis is above all political and reflects the inability of western democracies to resolve more than 20 years of accumulated problems that require drastic action to reform the economic and social structure.

Democratically elected politicians are loathe to make unpopular decisions that might compromise their re-election. Hard choices are delayed until external conditions, such as access to financial markets, make them inevitable. The emergency becomes the main driving force behind political action and a way of justifying unpopular decisions to voters. At that point, however, the situation becomes so dire that the cure must be even more drastic. The resulting austerity depresses economic activity and threatens political and social cohesion.

While the crisis is not confined to Europe, it has affected principally the continent due to the complexity of its decision-

making mechanisms. Europe is impotent because it is incomplete. It is incomplete because – as the history of the United States demonstrates – the transfer of power from the local level to a federal government cannot be realised in a day, or in a few years, and is often followed by a profound political crisis.

The inability to resolve the problems posed by the crisis is not necessarily due to irrational behaviour by those who govern, but rather to the incentives that exist within the democratic processes that are deeply rooted in our societies. If these bonds are not resolved there is the risk that the crisis will worsen and endanger the very existence of democracy in Europe.

This introductory chapter examines a number of issues that have characterised the decision-making process in industrially advanced countries, in particular in Europe, and explain the complexity of the crisis that is gripping the west. It traces a common thread among the more specific topics that are then considered in the various chapters. The first five topics are common to the majority of industrially advanced countries while the sixth is specific to Europe.

A first set of problems is linked to the difficulty that Western societies have had in understanding the causes of the current crisis. The analysis focuses mainly on the most salient aspects such as debt – public or private – which is the result of the imprudent behaviour of banks, households, companies and the public sector. The blame is very often laid elsewhere, including on banks (American or German), the financial sector, governments (of other countries), the rich, China, the World Trade Organisation and the euro. Naturally, the search for scapegoats has been a widespread response, above all for those who govern and those who protect them. This is dangerous because it diverts attention from the real problems and the implementation of effective remedies.

If one wants to understand the current crisis and avoid enacting incorrect measures to try and resolve it, one must ask why policies and practices that encouraged the excessive accumulation of debt were followed for such a long period. Why did the governments and parliaments of advanced countries deregulate financial markets, deregulation that was then exploited by banks to provide easy credit

to a wide array of subjects, including those who could not afford it? Why did public spending, financed by debt, increase faster than income? Why were interest rates left so low for so long? Why was bank supervision in many countries so short-sighted as to tolerate the assumption of an excessive amount of risk?

In most industrialised countries the capacity to sustain debt was overestimated because the expectations for growth were systematically too optimistic. Why were these errors of judgement made?

One hypothesis is that this type of error may be the product of the natural tendency of people to overestimate their future earnings based on past favourable conditions. As Alan Greenspan, President of the US Federal Reserve from 1987 to 2006, told the BBC in 2009: "The crisis will happen again but it will be different. They [financial crises] are all different, but they have one fundamental source. That is the unquenchable ability of human beings when confronted with long periods of prosperity to presume that it will continue." According to this thesis, the current crisis is not very different from those of the past, only more acute because it spread globally.

A more credible hypothesis is that the overestimation of economic growth has deeper roots. The radical changes that have been affecting the global economy for more than 20 years – especially with regard to the structure of trade and technological processes – are calling into question industrialised countries' growth model and the sustainability of their social system. The crisis is structural and cannot be confronted only with the classic macroeconomic recipes. There must be more profound action that looks to better integrate the economic system in the new global context.

This thesis is confirmed by the differences that have opened in Europe since the birth of the single currency. Countries that have done the best job adapting to the dynamics of the new international context – reforming their labour market while investing in education, research and development and infrastructure – are the ones that have borrowed less, had more sustainable economic growth and confronted the crisis better. The countries that have remained on the margins of global integration, those that delayed reforms and based

their development mainly on the domestic market, have become less competitive, were unable to avoid taking on excessive debt and were more affected by the crisis.

Consider the experience of Italy. The country has opened up particularly slowly to international trade in the past 20 years and instead has concentrated on the development of the domestic market where national companies are protected and competition is limited. This development is a product of the inability of those who governed, as well as opinion-makers and labour unions, to understand and deal with the processes of globalisation taking place in the world. The national media has long given ample space to the thesis that the Italian economy was less affected than others by the crisis and was coming out better. This is in stark contrast to the statistical evidence. The cognitive dissonance propagated for years in the country has made waking up to reality even more abrupt.

The second problem is the tendency in democracies to postpone politically costly adjustment measures until they become absolutely necessary to avoid a financial crisis. The policy actions are prepared under emergency conditions when it is obvious to everybody that not acting would have dramatic effects. Only on the verge of the precipice do unpopular choices become acceptable for politicians and people in general.

The reform of the pension system is a clear example. It has long been known that the increase in life expectancy and the trend of slowing productivity in advanced countries have made the welfare system unsustainable. But as long as the system is funded, including through debt, without too much difficulty, the perception of the seriousness of the problem remains limited and proposals for reform are delayed. The opposition posed by those who defend the so-called 'acquired rights' prevails over the forces of reform. The political cost of change is higher than that of keeping the system unchanged. Only when financial markets are no longer willing to invest in the country, and the difference in interest rates on government bonds – the spread – rises does the public wake up to the risk of insolvency and the reality that pensions can no longer be paid. Only at that point does

the government accept the need to reform the system and find the courage to carry it out.

In Italy, for instance, a package of fiscal reforms, including a robust pension reform, was adopted in December 2011 by the government with the telling name of “Save Italy” to explain to people that without the changes the country would go bankrupt.

The inability to make important decisions before the threat of a crisis, however, does not affect only Europe. In the United States, an agreement on the fiscal cliff was found only a few hours before the deadline and only due to the fear that ‘falling over the cliff’ would have resulted in serious consequences for the American economy. Knowing that other countries have similar problems, however, does not provide much comfort. In the European case, the inability to make decisions puts at risk the entire institutional structure and the survival of the single currency, with potentially much more significant effects.

The third problem, which is connected to the previous one, concerns the tendency of governments to adopt incomplete solutions that address only part of the problem and aim above all to buy time. When decisions are made in an emergency situation, they are unlikely to resolve highly complex and long-ignored problems. Decisions made in these conditions seek to ‘plug the holes’ and buy time until more complete answers can be given at a later date. But following the implementation of the most urgent measures, the pressure to find comprehensive solutions diminishes. The political incentive to carry through on more fundamental changes wanes, especially if the changes require structural reforms that hit long-established benefits.

The emergency measures generally focus on changing taxes. Structural measures, which have an impact on the economy’s growth potential and thus on the sustainability of public finances, are instead postponed to a later stage. In Italy, the decision to deal with the crisis in two steps was even made explicit: a first step of austerity measures and a second one for the reform and growth measures. First the “Save Italy” package of measures was adopted in late 2011, to be followed by “Grow Italy”. The first part immediately produced

strong recessionary effects while the second part was drained of content. In terms of political consensus, the result of this strategy has been rather disappointing.

Again, this behaviour is not exclusively characteristic of Europe. The solution found in late 2012 to the problem of the fiscal cliff in the United States produced only a partial answer to much broader questions that concern the structure of public finances and the American welfare system. The search for more definitive solutions was postponed to a later stage.

The fourth issue concerns the tension between short-term measures to quickly exit the crisis and long-term ones aimed at preventing a recurrence of the crisis. The dilemma concerns in particular the measures regarding the financial system, which must be reformed to avoid future extremes of indebtedness. Putting the responsibility more squarely on those who provide credit and having them take some of the losses in the case of a default generally garners strong political consensus. The implementation of these measures with the crisis still ongoing, however, risks leading to the flight of the few remaining creditors and exacerbating the situation with the possibility of precipitating contagion. Conversely, stabilising the financial system and keeping open the flow of credit in a recession sometimes requires supporting creditors, banks in particular, including with public funds. Such action, however, is met with strong resistance from the public, because help is extended to those who in the past have taken on too much risk and because it is likely to create the incentive to continue such behaviour in the future.

The problem occurred in the United States when the federal government decided not to use public funds to save Lehman Brothers in September 2008, due to the fear of a negative reaction from voters just a few weeks before the presidential election. Only after the collapse of the market caused by the failure of Lehman Brothers did Congress agree to vote a massive financial package to support the financial system and avoid knock-on effects. The US Treasury used those funds to recapitalise major banks, strengthening their assets and avoiding a credit crunch that would have further aggravated the recession. The move nevertheless provoked strong

criticism in US public opinion and political circles from Occupy Wall Street to the Tea Party.

In continental Europe, there have been no major bank failures. The downside of this is that Europeans have not had direct experience with the effects of a banking crisis and consequently they continue to have a strong aversion to the use of public funds to solve the problems of the banking sector. This has discouraged European political authorities from taking direct action, as happened in the United States, to secure the assets of the banks. The system has been progressively weakened, fuelling a ruinous link between sovereign risk and bank risk that prolonged the crisis and dried up credit to the private sector.

In Italy, for instance, few banks made use of public funds to cope with their difficulties. The onerous conditions attached to the use of the funds, which were dispersed in the form of government loans made at high interest rates, have led banks to reduce their leverage primarily through a reduction in credit extended to households and businesses, with sharp recessionary effects on the economy. The public's opposition to government intervention to shore up the banking system led to the opposite effect of what was desired and accentuated the crisis.

The fifth issue concerns the role of central banks that emerged during the crisis. When they intervene to counter financial turmoil, central banks reduce the pressure that markets exert on politicians and facilitate the postponement of unpopular decisions. Central banks can thus buy time so that temporary solutions can be transformed into definitive reforms. One example is the distribution of abundant liquidity, which mitigates the difficulties of the banking system thereby allowing governments to avoid using public funds to strengthen banks' capital. Another example is the purchase of government bonds on the market, which reduces the pressure on governments to improve their finances and implement structural reforms. In this way, monetary policy is used to deal with financial and fiscal problems that are the direct responsibility of governments and banking regulators.

The central bank is thus faced with a dilemma. On the one hand, if it continues to act indefinitely, it transfers the burden to taxpayers through inflation. On the other hand, if the central bank decides not to intervene it can put financial stability at risk and therefore price stability, which is its key responsibility. The central bank therefore finds itself with the tools that can directly affect financial markets and, through the pressure these exert, also governments. In one way or another, the central bank assumes a political role, unexpected and in some regard unwanted, without legitimacy and with the risk of losing its independence.

The problem does not exist only in Europe. In the United States, the Federal Reserve has made large purchases of government bonds, taking on a large part of the risks associated with the system's over-indebtedness. This reduced the pressure on the president and Congress to adopt measures to adjust public finances. The continuation of this policy shifts the cost of adjustment from debtors to creditors and ultimately to taxpayers. The central bank has become the subject of bitter political debate because of the redistributive impact of its policies on people's income and wealth.

In the eurozone the problem is even more complex because the debt crisis of some countries has endangered the unity of monetary policy. The European Central Bank intervened in some countries' government bond markets to stabilise the transmission mechanism of its monetary policy. In doing so, it assumed the risk of default of the securities purchased, which in extreme cases could result in a transfer of resources between countries. The ECB also created an incentive for governments to postpone taking steps to improve their finances.

In the summer of 2011, following the commitment of the Italian and Spanish governments to realise a number of structural and financial measures, the European Central Bank intervened by purchasing the two countries' sovereign bonds. A few days after the ECB's intervention, with calm having returned to the markets, the measures taken in Italy by decree were called into question. Structural reforms that had been requested by European institutions were postponed. Market tensions were reignited, forcing the ECB to

intervene even more aggressively, which under those circumstances became unsustainable. This is why the European Central Bank decided, a year later, that its open market operations would be carried out only if the countries agreed to a programme of fiscal and structural adjustment that would be monitored by European and international institutions.

The last issue, which is mainly European, concerns the incompleteness of the euro and the need for stronger institutions. "To overcome the crisis we need more Europe", is the refrain one constantly hears. But "more Europe" entails transferring power over important areas of economic policy from the national to the European level. This move does not enjoy broad popular backing, as shown by the growth of nationalist parties in many countries. The same national authorities that say they favour "more Europe" are opposing it with their actions because they do not want to relinquish their prerogatives unless forced to do so. On the other hand, the European Union is founded on the principle of subsidiarity, which assigns powers to the EU only if they cannot be exercised better at the national level. One or more crises may be necessary to convince people and their governments that the exercise of power at the local level is inadequate and that greater integration is needed.

A further complication arises from the fact that those who decide at the European level, that is to say the heads of government and their ministers in the various configurations of the European Council, are elected by the voters in their respective countries. "All politics is local", not only in Europe, as noted in the celebrated phrase of Tip O'Neill, speaker of the US House of Representatives in the 1970s and 1980s. In Europe, the problem is more complicated because granting new powers to the supranational level can legitimately take place only with the consent of all countries. For competencies that have already been allocated to the EU, such as the single market, decisions are made by qualified majority vote. For national competencies that still must be transferred to the EU, there is no way around the need to have the consent of all member countries. This applies in particular to the creation of new

institutions, such as the European bail-out fund, which did not exist at the time the monetary union was launched.

Obtaining the consent of all governments and their respective electorates to give more powers to the EU takes time, time that does not necessarily coincide with the functioning of financial markets. In addition, governments do not perceive the need for change without the pressure imposed by the markets. This explains the difficult process of European integration where ineffective and partial decisions, often made at the last minute, must be reviewed and corrected. This is nevertheless the way the EU has been built up to now. Even in the United States, the Federal Reserve was founded only in 1913, more than a century after a currency union and following numerous banking crises. The federal welfare system came about in the second half of the 1930s, following the Great Depression.

The six issues outlined above help explain why the euro crisis has lasted so long and why it will not be resolved quickly even if a repeat of the most acute phases of recent years is avoided. The tendency of nationally elected European politicians to make decisions only when under pressure from the markets, without a comprehensive long-term vision and with the fear of offending domestic political sensibilities, explains why the adjustment was strongly recessionary and threatens to undermine the internal cohesion of the individual countries and the confidence in the European project. It also explains why the integration process has nevertheless proceeded, even if in small steps, and why the euro has not collapsed as many had predicted.

The fundamental condition for the European Union to continue down the path of integration depends on the ability of the region's citizens and their leaders to understand, even in the face of difficulties, that to overcome the crisis far-reaching economic reforms and further progress towards European unification must be achieved. Although difficult and in some cases painful, these choices are nevertheless preferable to the disaster of immobility or backtracking.

This is the lens through which the following pages should be read. The themes of the book are developed in 20 short chapters,

which are not strictly related to each other and discuss issues that have been widely debated since the outbreak of the crisis. The conclusions point to the roads European democracies can follow to avoid finding their backs against the wall in times of trouble while expressing to the fullest their sovereignty in the fundamental choices they will have to make. There follows a chronology of the main European economic and political events from the end of 2009 to the end of 2012.

This book is the result of reflections and numerous discussions that took place throughout 2012 with many colleagues, in particular those of the Weatherhead Center for International Affairs at Harvard University. I extend my deepest thanks to them, although the opinions I've expressed are strictly personal.

1. DEAD ON ARRIVAL

The euro's demise was foreseen even before the currency had been born. Martin Feldstein of Harvard University wrote in 1997 in the journal "Foreign Affairs" that a currency without a state cannot survive for long. Now the euro risks undermining the peace that Europe brought about following the Second World War.

The crisis, which broke out just after the euro's ten-year anniversary, appears to confirm Feldstein's prophecy. Europe found itself unprepared to deal with a period of acute financial instability. Countries diverged ever more. Political tensions were exacerbated, particularly among creditor and debtor countries, that is to say, between the continent's north and south. Confidence in European institutions fell to historic lows.

Europe is at a crossroads. To overcome the crisis and avoid the implosion of the euro and with it the whole European project, there must be further progress towards full political integration. The basic question is whether countries can make further progress towards the political unification of the continent so as to make it resistant to future crises. The opposition to further transfers of sovereignty to the EU is strong, especially in some countries. The margin for amending the treaties is virtually non-existent. Although important steps were taken at the beginning of the crisis, which immediately reduced the risk of a break-up, the economic and social differences among member countries remain large and may even increase. This is why many international investors withdrew their money from the continent, especially from the weaker eurozone countries, prolonging the crisis. The fear is that the creation of the euro is the result of a political will that does not sufficiently take into account the differences between the member countries.

This negative view on the future of the euro, very common outside Europe, focuses on the political dimension of the project, which is certainly important. Germany's unification following the fall of the Berlin Wall altered the equilibrium on which the EU had been constructed since the beginning and gave the German currency an even more dominant role than it already had after the end of the Second World War. Germany's growing monetary hegemony created many problems for other countries and put at risk the economic and political integrity of the European Community. The refusal by the German central bank, the Bundesbank, on multiple occasions to help the weaker countries cope with the tensions in the financial markets led to devaluations of these countries' currencies in the 1980s and 1990s, and were regarded as national humiliations. For example, in the spring of 1983 French President François Mitterand was forced to change government and economic policy in order to avoid an excessive devaluation of the French franc. Another episode came in September 1992 when the Italian lira and British pound were forced out of the European Monetary System after the Bundesbank refused to loosen the monetary conditions that anchored the system.

The goal of the single currency was to take away from Germany an instrument of financial and political dominance that was considered to be excessive. The euro was supposed to enable the continent to counter American financial hegemony that is exercised through the dollar's role in international markets. With their currency Europeans thought that they would be in a better position to protect themselves from American policy choices.

A monetary union, however, requires certain prerequisites, some of which were missing in Europe. The economic literature, inspired in particular by the work of Nobel laureate Robert Mundell, defined the criteria to assess whether an economic and monetary area is optimal. The literature considered in particular the extent of the integration and flexibility of financial markets and the mobility of the means of production – capital and labour. If a region is hit by a negative event that reduces income or employment, adjustment can come about through the reduction of prices and costs if there is adequate market flexibility or through mobility as labour moves to

more productive areas. Without these adjustment mechanisms, the areas most adversely affected by the negative event risk becoming further depressed thereby jeopardising the stability of the system.

The comparison with the US shows that Europe does not come close to meeting the requirements of being an optimal currency area. European markets are less flexible than in the US, while at the same time labour and capital mobility is more limited. In addition, Europe lacks the instruments to redistribute wealth to compensate for the lack of flexibility and mobility. The European budget represents about 1% of the continent's GDP, not enough to absorb the effects of any differences between the member countries.

The monetary union was born incomplete, and now risks breaking apart. This incompleteness is not new and has in fact from the beginning been a constant of, if not the motive for, the move towards European unification. Trade integration initially focused on only a few products and then developed into the single market for goods and services in the second half of the 1980s. Integration came to the financial system only in 1990, when capital movements were liberalised, while the banking system has remained subject to national regulations, albeit within the framework of progressively more demanding EU rules.

The single currency was also incomplete when it was created. It was clear from the outset that the monetary union would not be accompanied by a fiscal union, or, as the Germans call it, a transfer union. There was no consensus – in fact, there was strong opposition, not only in Germany but also in France – for the transfer of budgetary matters from the member countries to the European Union. The Maastricht Treaty (1992) even contains a rule forbidding countries from assuming the liabilities of other EU members. This provision was needed to convince those, especially the Nordic countries, that feared that the monetary union would over time become a system for transferring resources from richer countries to poorer ones similar to what exists internally in some countries such as Germany (between west and east) and Italy (between north and south).

Why was the decision taken to proceed with the creation of the euro even though it was known that it was flawed and could create significant problems in the future? Why did politics prevail over economic considerations, which are now taking their revenge?

To answer this question, one must ask what the alternatives were. There were at least three.

The first was to continue with the existing system that had been in place since the collapse of the Bretton Woods agreement in the summer of 1971, trying to maintain a certain degree of monetary stability in Europe through bilateral agreements aimed at limiting fluctuations between the currencies of various countries. The system had, however, proved to be ineffective. The so-called 'currency snake' and the subsequent European Monetary System were unable to ensure stable exchange rates between the currencies of European countries. The multiple changes in the parity exchange rates, and the eventual widening of the fluctuation band in August 1993, resulted in exchange rates that did not always reflect countries' competitiveness. On the contrary, they fuelled trade tensions and endangered the single market.

Without monetary stability it is impossible to promote a deep and lasting integration of markets, which is necessary to foster sustained economic growth. Mundell demonstrated the impossibility of achieving exchange rate stability when there is complete freedom of movement of capital if individual countries remain in charge of their monetary policy. One of three conditions must be given up – financial integration, currency stability or monetary sovereignty – otherwise there is the risk of a return to protectionism. French President Jacques Chirac's public grievances against Italy following the country's exit from the EMS in 1992 and the devaluation of the lira highlight the damage that a big variation in exchange rates can inflict on other countries' economies.

The experience of the two decades that followed the end of Bretton Woods showed that while Europe, especially continental Europe, is not an optimal currency area, it is also not an area in which it is desirable to have currencies fluctuating freely. Greater economic and financial integration were necessary to reduce the

possibility that countries gain a competitive advantage through fluctuations in exchange rates.

The second option was to strengthen monetary stability around the strongest currency, the German mark. This solution, however, posed a number of obvious political and economic problems. Germany itself did not want to assume the burden of implementing a monetary policy for the whole EU. The mandate of the Bundesbank was to ensure the stability of the mark, not other currencies.

It is worth remembering one of the episodes that best shows the way the European Monetary System worked. On 5-6 September 1992, the ministers and governors of central banks of European countries met in Bath, England, to try to resolve the tension that had been unleashed on the currency markets over the summer and risked bringing down the system. The German central bank had in the previous months raised interest rates to counter the inflationary pressure that had emerged following unification. The increase in yields in Germany attracted capital from other European countries, driving up interest rates across Europe at a time when economic activity was slowing. Public disagreements among monetary authorities in the various countries fuelled ongoing speculation in the financial markets that the monetary system would not last. In Bath, Helmut Schlesinger, the Bundesbank president, was repeatedly asked to help reduce tensions by giving a sign that there would be some easing of monetary policy. Schlesinger refused, pointing out that the Bundesbank's mandate was to ensure price stability in Germany and not in other countries. He even threatened to leave the meeting if his counterparts made the same request again.

That event – which effectively put an end to the existing monetary system and perhaps hastened the advent of the euro – demonstrated, if that was still necessary, that monetary stability in Europe could not be placed only in the hands of the German central bank. Only a European Central Bank could ensure stability.

To make sense of the changes that have occurred in the last 20 years, it is interesting to note how two decades after Bath almost the same situation arose, but with a different outcome. On 6 September 2012, in Frankfurt, the Governing Council of the European Central

Bank approved the programme of potentially unlimited open market operations to counter the risk of the break-up of the euro. The President of the Bundesbank, Jens Weidmann, voted against the programme, the only one to do so. His vote had no effect on the final outcome because ECB decisions are taken by majority vote and nobody has veto power.

The third solution would have been to create a more 'exclusive' eurozone restricted to countries that were already strongly integrated into a sort of macro-area. Membership would have then been subsequently extended to other countries when they had reached an adequate degree of convergence.

This solution also posed a series of problems.

The first was the risk of splitting Europe in two. This was feared by the more European-oriented Germans such as Helmut Kohl, the German chancellor at the time monetary union was being discussed, who wanted to protect their economy from the effects of competitive devaluations of other currencies. This solution also worried countries that might be forced to stay out such as Italy and Spain as well as France, which feared remaining isolated in a mark-centric currency.

The second problem was how to select the group of countries that would initially take part and the criteria to use when deciding which countries would be admitted later. Using gross domestic product per capita was politically unacceptable because it would create a euro only for the 'rich' and would leave out poorer countries such as Spain and Portugal that were rapidly catching up.

Using the level of public debt could have been another criterion, but it would have excluded for many years Italy and Belgium, two founding members of the EU, but not Spain and Ireland, which later showed themselves to be much weaker. The only easy-to-apply objective criterion was that of government deficit, which was not to exceed 3% of GDP in the year preceding the evaluation of the level of convergence.

In the second half of the 1990s most European countries had a deficit higher than the threshold. At that point the decision could have been taken to postpone the adoption of the single currency until

the conditions of convergence were fully met by a sufficient number of countries. Instead, European leaders decided to launch the euro as foreseen in the treaty, on 1 January 1999, since several countries enacted extraordinary public finance measures to meet the criteria in the last possible year. The monetary union began with 11 countries, and a year later Greece joined. As with many political decisions, the choice to launch the monetary union was probably not optimal, but the alternatives were no better.

In hindsight, it is legitimate to question whether it would have been better to postpone the launch of the euro.

2. A PREMATURE BIRTH

The birth of the euro could have been postponed for a few years to allow for the full economic and political convergence of the member countries. This would have avoided putting the cart before the horse, but then monetary union probably never would have happened.

Markets cannot fully integrate as long as there are different currencies. And without the integration of markets there cannot be the optimal conditions for a monetary union. It is the dog chasing its tail. A single currency promotes the integration of markets, but the process takes time.

The euro's first ten years provided a strong push towards economic and financial integration in Europe, but the integration did not advance enough to contain the impact of the global crisis. Predictions that the euro would push countries to reform their markets, in particular to make them more flexible and able to absorb external shocks, have proved optimistic. The Lisbon Agenda, launched in 2000 in parallel with the euro, was not enough to induce the member countries, especially the biggest laggards, to implement the reforms necessary to make their economies more competitive. It was an illusion to believe that reforms would be made just because Europe asked for them.

The euro may even have put a brake on structural reforms, especially in countries that had initially received a strong economic boost from entry into the monetary union due to the lower interest rates and stability provided by the new currency. This is what happened in Spain, whose economy grew rapidly in the early years of the euro creating jobs and raising the standard of living. In this favourable context there was no longer the political incentive to eliminate the rigidity that characterised the labour market, in particular with regard to wage indexation. Only after the explosion

of the crisis and the rise in unemployment was there an awareness that the labour market needed to be reformed and only then was the political will found to do it.

One can question whether the incentive to carry out the reforms would have been stronger if the countries had not joined the euro. Actually, the possibility to devalue the currency at the first signs of crisis has often been an easier way out for troubled countries because it helps them regain competitiveness while avoiding reforms that often are politically costly. In Italy, major reforms, such as that made to the pension system, are realised in periods of crisis such as immediately after the exit of the lira from the EMS in September 1992.

The opposite view – that reforms can also be made by countries using the euro – is confirmed by Germany, which carried out important structural reforms during the government of Gerhard Schröder. At the time the economic environment was also very negative. At the beginning of the monetary union, Germany was considered the ‘sick man’ of Europe: economic growth was at an historic low and unemployment was higher than any time since the 1930s. Faced with these difficulties, Germany was able to find, thanks to a far-sighted leader, the impulse to implement reforms that in a few years transformed the country into the most competitive in Europe.

It is worth remembering that the accomplishment cost the chancellor his job. As Jean-Claude Juncker, Luxembourg’s Prime Minister, famously said: “We know what reforms need to be done, but we do not know how to win elections after they have been made.”

In theory, reforms should be made when the economy is healthy and public finances are sound. Some leeway in the budget can then be used to relieve the political cost of reforms and possibly compensate those most negatively affected. But when the economy is doing well there is less incentive to promote change. The political consensus to start the reforms tends to form when the economic situation is difficult and there are neither alternatives nor scapegoats.

The decision to launch the monetary union was made when it became apparent that the fluctuations between European currencies and the repeated currency crises impeded economic convergence. The need to change the system emerged only when it became clear that it was not possible to guarantee monetary stability in a system of full capital mobility if every country continued to have its own monetary policy. Only after repeated currency crises did it become evident that the monetary system had to be changed through greater integration.

It was not an easy decision. Many national authorities, including the central banks, did not want to lose their autonomy or their illusions of autonomy. Jacques Delors, President of the European Commission at the time, skilfully convinced the central bank governors that under certain conditions the union could be achieved. The unanimously approved Delors Report became the basis for the negotiations on monetary union.

This is, after all, the way in which the European Union has been built since its birth, adopting new policies or institutions and modifying them to overcome the problems that had arisen in earlier stages of integration. The European Coal and Steel Community was created in 1952 to avoid damaging competition in sectors regarded as strategic for post-war reconstruction. The common market, created by the treaties of 1957, was the direct extension of that agreement. The expansion of the internal market in the mid-1980s to allow full mobility not only of goods but also of services, capital and people, became necessary to complete the integration of trade.

The principle of subsidiarity on which the EU is based dictates that competencies should be exercised as close as possible to the people and that they should shift away from the member states only when the EU can do a better job. To transfer sovereignty it must be evident to everybody that the exercise of power at the national level is inefficient and creates problems that can only be overcome through a centralisation of power. The existence of these problems emerges only when a crisis erupts. The crises are, in fact, the engine of the EU. Without a crisis, the status quo prevails.

Jean Monnet, one of the European Union's founding fathers, coined a symbolic phrase to describe the way European integration proceeds: "Europe will not be built all at once. It will be built during the crises and will be the result of the solutions adopted in those crises."

Many people, including the founding fathers, were aware that the monetary union was fragile and incomplete when it was created. It was known that sooner or later problems would emerge, although nobody could have anticipated the extent of the global crisis that hit the euro only ten years after its birth. It was assumed that as in the past, when a crisis emerged the advantages of proceeding with integration would in any case exceed the costs of turning back, thus creating the conditions for further institutional integration. Europe is like a cyclist, if it stops moving forward, it falls over.

Having faith in Europe's ability to move ahead in the face of any crisis presupposes strong political cohesion among the member countries, a cohesion that could someday fray. Placing the currency ahead of policy is like putting the cart before the horse. The consequences can be permanent. And in any case, this way of constructing the EU through the various crises is highly unstable and very inefficient. The question is whether there are better ways to move forward.

The failure of the European Convention and the Constitutional Treaty, which was rejected by French and Dutch referenda in 2005, shows that Europeans resist grand institutional designs they do not understand and that shift power away from their country. The principle of subsidiarity is deeply rooted, not only among the public but also within the governments.

Regarding monetary union, the Werner plan of 1973 called for the transfer of a wide range of responsibilities to the European Community, including fiscal policy, that were in some way related to money. The plan was never carried out because it was too comprehensive. Insisting on pursuing this approach would not have yielded any results.

The alternative, continuing with a step-by-step approach to integration, led to other problems that countries have tried to solve

with partial solutions. Governments were convinced that even without a full fiscal union, basic rules embedded in a stability pact would be enough to maintain fiscal discipline. In addition, the market would have watched, and punished, as necessary, countries that strayed. The great fear, particularly in Germany, which was about to give up the mark, was that the euro would bring about the transfer of resources from the richer countries to the less developed ones. Only Kohl's promise that there would never be a system of European transfers made it possible to overcome German scepticism.

The same was true in other areas such as financial regulation and banking supervision. Despite the widespread belief, at least in academic circles, that a single currency required a banking union with a single regulator, the conservative forces entrenched in national institutions prevailed for a long time. The aversion towards the harmonisation of banking regulation continued during the early years of the euro and curbed the creation of a truly integrated financial market. The crisis showed, as will be demonstrated later, that the system had to be changed. But until the crisis hit, it was difficult to convince naysayers that a decentralised supervisory system would not work.

The national authorities wanted to transfer only monetary matters to the European Union while holding onto the rest. In this context, the alternative would have been to postpone the start of the monetary union. It is not a given that the delay would have created the conditions for the strengthening of the countries' will to move ahead with the political union ahead of the monetary union. It is an illusion to think that Europe's political union could have followed a different path from what actually happened in recent years (a gradual transfer of responsibilities). Starting with the currency was probably not the best way to move eventually to political union, but perhaps there was no other way forward.

It is not only the European experience that shows that political integration occurs in spurts and often during a crisis. It took more than a century and a half to build the federal system of government in the United States. The pooling of the states' debt was decided by Treasury Secretary Alexander Hamilton at the end of the 18th

century, to share the costs of the American Revolution, in exchange for the centralising of taxing authority. Nevertheless, the federal budget had a limited role until the 1930s, when Franklin Roosevelt launched a series of federal spending programmes. The individual states continued to pile up debt individually and only after several bankruptcies, connected also to the Civil War, were stringent budget rules imposed. The Federal Reserve was created only in 1913, following several banking crises, to act as the lender of last resort during liquidity crises.

The euro is an unprecedented experiment in that it is the currency of different countries that are not fully politically and economically integrated. Only in a dream could it have been born equipped from day one with all the institutional characteristics of a consolidated currency.

Postponing the introduction of the euro was possible, but it is not a given that the ideal conditions for achieving a full monetary and fiscal union would have come about in the future. Monetary unification took place first because the monetary issues were relatively simpler to solve, although the way in which they were resolved contributed to creating other, more complex problems. The most difficult issues are typically addressed only when they can no longer be avoided and the process of European integration has not proved to be an exception to this rule.

3. NO TURNING BACK

Exit the euro, adopt a new currency (even temporarily) to clean up the country's finances, devalue and then potentially re-enter...seems like an appealing solution. It has been proposed, like sabbaticals enjoyed by university professors, to allow distressed countries to have time off so they can regain competitiveness and make adjustments to then rejoin with a more favourable exchange rate. Only when perched on the edge of the precipice did it become clear that exiting the euro was a leap into the unknown.

A country's exit from the euro would be a dramatic event. Greece got close with the two elections held in the spring of 2012, when voters realised the possible consequences and decided to remain part of the eurozone.

The complexity of a move such as the exit from the euro makes it practically impossible to achieve. The Maastricht Treaty does not provide for this eventuality. There is an explicit reference to the irrevocable fixing of exchange rates of existing currencies and the conversion to the new currency. The treaty, which was ratified democratically by all member states, was not modified in this regard, not even as part of the 2007 Lisbon Treaty that instead provides for the possibility of an exit from the EU. The exit of a country from the euro would therefore bring with it a total withdrawal from the European Union.

A unilateral decision to leave the euro would set in motion a series of disputes between the country leaving and the rest of the EU as they argued over the losses incurred following the redenomination of contracts in the new currency. If the currency of the country that leaves decreased in value against the euro, the residents would probably not be able to repay their euro-denominated debts. The country would not be able to repay the aid received. The national central bank would not be able to repay the other eurozone central banks the debt owed, which are recorded in

the EU's internal payment system known as Target2. The insolvency would cause significant losses for players in other euro countries including the central banks and governments themselves.

The disputes would encompass the relationships among private individuals as well as those between the private and public sector. It is unlikely the country exiting the euro would be able to issue bonds denominated in the new currency in the financial markets because investors would fear that they would quickly lose value. The national central bank would have to buy up the new debt creating the conditions for runaway inflation. The price increases would reduce the real value of debt and wages, especially in the public sector.

One way to limit the possible disputes with the other EU countries would be to negotiate the exit from the euro while adopting a new treaty that would have to be ratified by all countries.

The expectation that a country was preparing to leave the euro would lead people to withdraw their bank savings immediately and keep it in cash or move it abroad. To avoid the collapse of the banking system, the government would have to intervene by putting a limit on the daily amount of cash that could be withdrawn. The outflow of savings to other countries could only be stopped by imposing controls on capital movements, such as those put in place in Argentina when the government suspended the convertibility of the peso. People's savings would effectively be expropriated. This move, which would contradict the EU provisions on the free movement of people and capital, would illicit strong negative reactions in the country.

People would seek to protect their income and savings from the risk of the devaluation of the new currency and inflation by continuing to use cash in euros or by pegging prices to the euro. There would in effect be a double circulation of money. The 'good' currency, the euro, would be used mainly for transactions between individuals while the 'bad' currency, the new one, would be used primarily by the public sector such as for the payment of salaries and pensions. A similar system is in place in many Balkan countries where many transactions are carried out in euros.

The dual currency system would defeat the attempt to regain competitiveness through the introduction of a new currency. The constant reference to the euro would cause a large proportion of prices to remain unchanged thus preventing the adjustment connected to the devaluation of the new currency. The fixing of salaries in euros, or pegged to the euro, especially in the private sector, would not lead to a change in labour costs and exports would not become more competitive.

The introduction of the new currency would impoverish the part of the population most dependent on the public sector and those unable to protect their savings against inflation. The rise in inflation would benefit mainly the state by reducing the real value of public debt and all financial activity. This would lead to a redistribution of income within the country from savers to debtors. The country's social cohesion would be put to the test.

The exit from the euro would close the door to international financial markets, and the country would no longer be able to borrow. Aid from the international community would become necessary for the country to obtain the foreign currency necessary to purchase imported goods. The shortage of foreign supplies in key areas such as healthcare could lead to a genuine social crisis as was seen in Greece in the summer of 2012.

The scenario faced by a country exiting the euro promises to be complex and full of economic, political and social uncertainties. It is a leap into the unknown and can strain the country's social stability and democratic credentials. The Greeks realised this when in the spring of 2012 they voted twice in favour of parties that opposed Greece's exit from the euro. Forced to pick between the 'good' and the 'bad' currency, the Greeks chose the former, well aware that the country's exit from the euro would not solve the structural problems, such as tax evasion, an inefficient bureaucracy, a rigid labour market and an inefficient judicial system. The exit from the euro and the EU would not have facilitated any reforms.

A country's decision on whether to stay in the euro ultimately depends on the perception of the economic and social costs of the exit compared to the costs of staying. It is not an easy assessment to

make because the costs of staying in the euro are immediately felt by the economic system while the costs of an eventual exit can only be estimated. Moreover, it is in the interests of opposition political parties and those carrying out an election campaign with populist promises to present the exit from the euro as an easy alternative. If people are attracted by these appeals, they risk pulling the country dangerously close to the precipice.

The exit of a country from the euro would cause knock-on effects in the rest of the eurozone, as seen in the period of greatest tension that preceded the Greek elections. Financial markets would immediately wonder which other countries might follow down the same path. The risk that other countries could leave the euro would push people to withdraw their bank deposits, provoking a banking crisis. Contagion would be impossible to avoid without a European-wide safety net able to counteract the movement of capital that such an event would trigger.

In sum, a country's exit from the euro would have economic, social and political repercussions for both the country leaving and the rest of the system whose very survival would be called into question. It took time, probably too much time, for this to be understood – not only in Greece, but also in other parts of the EU such as Germany where for a long time there was a strong temptation to have Greece exit in the illusion that a smaller eurozone would be more cohesive. People were late in realising that the responsibility for the social and political drama caused by the exit from the euro of a country such as Greece would ultimately be attributed, rightly or wrongly, to Germany. All across Europe strong negative reactions towards Germany would have been triggered, with a huge political cost for the German leadership. German Chancellor Angela Merkel came to understand this only in the autumn of 2012 when she flew to Athens to demonstrate her solidarity for the fiscal adjustments implemented by Greece. Perhaps she could not have done it before the Greek vote in favour of the euro and the new government's decision to follow unambiguously the path of fiscal restructuring.

On the other hand, the threat of leaving the euro, as was publicly discussed in Italy during the 2013 election campaign, does not seem to be an effective negotiating strategy. Its main effect is to destabilise the markets with counterproductive effects for the country.

Resorting to blackmail also generates a climate of mistrust among the other European countries and is not conducive to convincing them to grant aid, which the Italian and Greek governments saw firsthand in the fall of 2011. It is no coincidence that the resignation of Greek Prime Minister George Papandreou occurred just a few days after his announcement that the country would hold a referendum on the euro, something the other eurozone countries rejected outright. It is also no coincidence that Italian Prime Minister Silvio Berlusconi resigned after his country's hypothetical exit from the euro had been floated in private talks with the governments of other eurozone members.

The debate on countries possibly leaving the euro aroused fear that strong currency members such as Germany or Finland might seek an exit. Some thought this scenario could play out if Northern European creditor countries got tired of transferring funds to finance the adjustment of those on the eurozone periphery. This fear would increase if the debtor countries decided not to reimburse their loans, thus leading to a loss for taxpayers in the creditor countries.

A strong country's decision to leave would produce the opposite effects of an exit by a weak country. There would be an influx of capital from other countries, as investors sought to take advantage of the presumed appreciation of the new currency. The transfer of deposits would create difficulties for the banking systems in other countries. To avoid this scenario, the country would have to restrict currency exchanges to residents only, again violating European law. To counter a possible revaluation of the new currency, the central bank would have to intervene, buying large sums of euros. A similar situation occurred in some countries that sought to avoid the appreciation of their currency during the crisis. Switzerland, for example, decided in September 2011 to put a cap on

the appreciation of the Swiss franc against the euro and declared it would buy unlimited amounts of euros to achieve this goal.

The appreciation of the new currency would result in a loss on euro-denominated investments held by the country's residents. The country's financial system would risk suffering heavy losses, which would also extend to the state due to the loans granted to other countries and to the central bank for its credits in euros accumulated with other banks in the system. By some estimates, which have a wide margin of error, the potential loss to countries like Germany and Finland, due to their exit from the euro, would be about 20% of gross domestic product.

Given these effects, leaving the euro would also dictate an 'exit' from the EU due to the repudiation of the joint commitments. The political tensions that would result from this scenario would put at serious risk the integration process, which would be unlikely to survive such a shock, especially if the country to leave had significant political weight such as Germany. The exit of Germany from the euro would effectively bring an end to the EU as it was conceived in the post-war period with resulting global political repercussions. Germany's exit from the euro, as some provocative commentators and rash politicians have called for, would precipitate the EU into an unprecedented political crisis and call into question the whole integration process.

On the whole, an exit from the euro by a weak or strong country would produce consequences that go far beyond the economic aspects on which academics dwell. It would have an impact on the future of the European Union and the international community. The euro is not only an economic project. It is part of a wider process of European political integration that began more than 60 years ago. "The collapse of the euro would be the collapse of Europe", said Angela Merkel in front of the German parliament, adding that "it must not happen".

Yet the possibility of a break-up of the euro, or a country's exit, is still being discussed. The crisis will not end as long as the idea remains on the table.

4. A CRISIS THAT GOT OFF ON THE WRONG FOOT

The euro crisis could not have started in a worse way. The discovery that Greek public accounts had been falsified for years created a climate of distrust among European governments and toward the EU institutions responsible for ensuring that rules are respected. This made it much more difficult to create a political consensus around extending financial help to Greece, and later other countries. Strengthening the EU's decision-making mechanisms also became more challenging. Had the crisis begun in Ireland or Portugal, it probably would have been resolved more rapidly and effectively.

The crisis erupted with the discovery of the hole in Greece's public accounts that Kostas Karamanlis' conservative government had caused in the run-up to the October 2009 election. The steep rise in public spending, made to try to win the election, had more than doubled the deficit in a couple of years from 6% to 15% of gross domestic product. The public debt had risen to 130% of GDP, 15 percentage points more than forecast.

The discovery was not immediate. The government that emerged from the elections, headed by the socialist leader George Papandreou, did not disclose immediately the extent of the problem and the continuous increase in the deficit figure from the autumn of 2009 and into early 2010 damaged the government's credibility. Corrective measures, presented in early 2010, were inadequate. International investors began to worry and interest rates on Greek government bonds rose rapidly.

In early 2010, Greece's European partners were faced with a country that essentially had lost control of its public finances, not due to external factors linked to the global crisis, but because of the previous government's mismanagement carried out in order to win the election. The new government did not give, however, any

indications that it understood the gravity of the problem or that it would be able to solve it.

Further analysis showed that Greek public finances had been on an unsustainable path for years. The pension system was outdated and allowed people to retire at a much younger age than in all other European countries. Wages in the public sector had more than doubled in less than a decade. Some expenses, in particular military spending, had remained hidden under the guise that it was necessary to protect state secrets, and official data would be revised after many years. The system for collecting statistics, which is linked to government offices and therefore not entirely independent, for years did not report budget figures accurately. The tax system was plagued by widespread corruption and inefficiency that favoured tax evasion. An updated land registry did not exist.

The emergence of such administrative backwardness and waste of public resources, at a time when the Greek government was asking for aid from the international community, provoked negative reactions in public opinion in other countries, particularly in Germany. “Why should a German worker who pays taxes and retires at 65 help a Greek who doesn’t pay taxes and retires at 50?”, said a headline in *Bild Zeitung*, a newspaper read daily by about 10 million Germans.

The discovery of the situation in which the Greek economy found itself fuelled a climate of distrust in Europe that complicated the decision-making process even within the individual countries. Many asked themselves: “Why didn’t we realise this earlier?” Although the problem exploded in 2009, the data had been incorrect ever since the introduction of the euro. Subsequent reviews showed that the Greek deficit had always been more than 3% of GDP, the limit stipulated by the treaty, even in the year the country entered the euro. Many strongly criticised the European Commission, which annually checks the state of the public finances of member countries and assesses their compliance with the criteria of the Stability Pact. In reality, the Commission bases its analysis on data supplied by the member states and therefore cannot know if the data are correct. The fault therefore rests with the countries that provide the data and the

national statistics offices that often are not independent of government control.

When the reform of the Stability Pact was launched in 2005, the European Commission tried to include rules to strengthen the independence of national statistical offices while also giving Eurostat, the European statistics institute, supervisory power over the national institutions. The proposal was rejected by the member states, in particular France and Germany, which did not want to give up their national prerogatives, even when it comes to statistics.

As often happens, the blame fell on the European institutions, even though they are not responsible for these problems nor do they have the powers to resolve them. These are powers that national governments have not wanted to cede. In addition, in the summer of 2009, the European Commissioner for Economic Affairs, Joaquin Almunia, had tried to alert the finance ministers that the Greek government accounts seemed dubious. However, nobody listened to him.

The state of disrepair of Greek public finances was long underestimated, even after the European Council began to examine the issue in early 2010, in the wake of the financial turmoil that increased the risk premium on Greek bonds. The proposal for corrective action on the budget was clearly insufficient given that the hole in the Greek public accounts was so much larger than originally thought. The uncertainty about the data led to several postponements on the decision regarding the aid package. Angela Merkel, in particular, feared that the German parliament would not approve a financial package without an independent opinion. The request for the International Monetary Fund to get involved was not only to have an independent evaluation, but also to negotiate with the Greek government an adjustment and monitoring programme.

The ECB and the European Commission initially opposed the involvement of the IMF. How can a currency remain independent if the intervention of an international organisation is requested, especially if that organisation's largest shareholder is the United States and the second-largest is China? A currency that needs the IMF is unlikely to be seen as credible and cannot aspire to become an

international reserve currency that can rival the dollar. On the other hand, the EU's institutional mechanisms proved unfit to handle a complex situation like the one created by the Greek crisis in which the country had to be persuaded to change course quickly to safeguard the stability of the euro's entire framework. The European Commission is in theory independent and has the power to assess and negotiate adjustment programmes with member countries. But after having underestimated Greece's budget hole and the restructuring measures required, it had lost the confidence of European governments. The European Central Bank could not and did not want to take on a role similar to that of the IMF, which would entail negotiating and monitoring a financial programme with one of the eurozone countries. The Eurogroup – the meeting of eurozone finance ministers – should have played a prominent role, but as the experience of the first decade of the euro has glaringly shown, the finance ministers do not like to criticise each other or interfere in other countries' policies. They prefer to delegate this role to someone else – if not to the European Commission, then to the International Monetary Fund.

The decision to involve the IMF was the product of European politicians' lack of confidence in Greece, the European Commission and ultimately themselves to manage relations with the Greek government. And so they decided to form the troika, bringing together the IMF, the European Commission and the ECB. The troika became the link between the European Council and the Greek government. As with all IMF programmes, the disbursement of financial aid was conditional on the troika's favourable opinion of the programme's progress. This did not, however, avoid conflicts between the troika, Greek authorities and other eurozone countries in various stages of their adjustment programmes.

The crisis got off on the wrong foot because it exploded in a country that not only had long falsified its public finances, but also had an economic and social framework that proved unable to implement the adjustments necessary to bring the country back on track within a reasonable timeframe.

The government was unable to implement the measures agreed in the programme regarding taxation, spending cuts and structural reforms. The lack of an updated land registry, for example, made it practically impossible to adopt a property tax, in particular on high-value properties. The widespread corruption in the public administration prevented the implementation of the government-mandated reforms. For example, an investigation was launched into the involvement of the Greek finance minister regarding the concealment of a list of tax evaders that had been sent by the French government. Local political pressures blocked the country from proceeding with its commitment to privatise state assets.

In addition to Greece's structural backwardness, the situation was exacerbated by a fragmented and litigious political system that did not facilitate the creation of a political consensus around the adjustment programme, as would happen in Ireland and Portugal. Throughout the entire crisis and up to 2012, the opposition battled the Papandreou government, undermining the social cohesion that was necessary to get the reforms accepted.

At the European negotiating table, the Greek government from the start grated on the nerves of the other countries' finance ministers by trying to call into question the previously agreed provisions. In just over two years, there were five Greek finance ministers and each one tried at the beginning of his mandate to renegotiate the terms of the programme. The firmness of the troika and the other countries throughout the negotiations with the Greek government can be explained in large part by the Byzantine behaviour of some of the Greek representatives in international forums.

The adjustment programme for Greece had been calibrated for a country with characteristics similar to those of an advanced economy, such as Ireland, Portugal or Latvia. The analysis carried out on the ground subsequently revealed a very different reality, one more like that of a developing country with a bloated public sector, a corrupt administrative system and an inefficient economy dependent on subsidies that was able to stay on its feet only through borrowing. The adjustment was ineffective because it was too heavily weighted

on the fiscal side for a country in which it was impossible to carry out reforms quickly.

If the nature of the situation had been known from the start, the structure of the programme would probably have been different, although it is not easy to understand in what way. Had Greece been given more time from the start to implement the adjustment policies, the financial cost to the other countries would have been even higher than €110 billion, about 60% of Greek GDP, paid in May 2010. It is unclear whether there would have been a political consensus, in particular from the IMF, in favour of an even bigger financial package. The alternative would have been to restructure immediately a large part of Greece's public debt. This would have reduced the contribution of other countries, but, as we shall see later, it would have brought the risk of the collapse of the Greek financial system and strong contagion to the rest of the eurozone.

Greece should not have joined the euro as early as it did, but after the launch of the single currency, European leaders did not want the EU to become a club restricted to a select few. The decision to have Greece enter the euro in 2001 was greeted with enthusiasm throughout Europe, just as would happen later when Slovakia, Cyprus, Malta, Slovenia and Estonia joined. Looking ahead, the entry of new countries will be examined much more closely, not only with regard to the convergence criteria laid down in the treaty, but also the ability of countries to implement economic policies necessary to participate in the single currency.

In hindsight, there can be extensive discussion on the way the Greek case was dealt with and what other solutions could have been more effective and caused less contagion. It must be remembered, however, that the Greek case was not just about economics. It called into question one of the fundamental points of the contract signed by the founding countries of the euro, a contract based on the reciprocal trust between governments with each country taking responsibility for its public accounts. It was not, therefore, only a financial crisis with the associated knock-on effects on the rest of the eurozone, but rather a political crisis that affected the very foundations of the EU. The solution to the crisis therefore could not address only Greece,

and instead had to consider the entire institutional structure. This is why the crisis has lasted so long and requires complex solutions.

5. NOT A CRISIS FOR EVERYBODY

The euro crisis has been complex to manage for several reasons including the fact that it manifested itself differently in the various EU countries. In countries directly affected by the crisis the impact was dramatic for millions of households and companies. In other countries the economic and social climate continued to be favourable and the negative repercussions of what was happening elsewhere were not felt for a very long time. The different economic effects in the various eurozone countries complicated the decision-making process and made resolving the crisis more difficult.

After the collapse of economic activity that followed the bankruptcy of Lehman Brothers in September 2008, it took about a year for the European economy to rebound although the rate of growth was different in the various countries. In those countries most open to international trade, such as Germany, the recovery was rapid, while in the more insular countries, such as Greece and Spain, the slowdown continued into 2010 and then worsened.

Germany and other Northern European countries were already on the road toward consolidating their economic recovery when the tensions over the Greek debt erupted in early 2010. In these countries, the recession had limited effects thanks in part to a series of temporary measures and to the flexibility of the labour market that limited the negative impact on employment. Germany's unemployment rate fell to below 7% in 2010 and then to about 6% in 2011. The average German worker has suffered relatively little due to the global economic crisis. Salaries even started to grow again after years of stagnation. German companies – which were able to latch onto the international recovery and demand coming from emerging markets – continued to invest in the most dynamic sectors, thanks in part to relatively favourable credit conditions.

On the whole, until the middle of 2012, there was no hint of a crisis in Germany or in most of Northern Europe. The decline in

interest rates, which pushed down yields on government bonds, led to significant savings for the public accounts and stimulated investment.

The relatively favourable economic and social conditions made it more difficult to grasp the gravity of the financial crisis hitting other countries and the eurozone as a whole. The different economic performances led some to think that the problems were mostly due to economic policy mistakes committed in other countries and the loss of competitiveness accumulated over the years. Data coming out of Greece confirmed this view. Ireland's difficulties, which emerged later and were due to excessive debt accumulated in the real estate sector, and in Portugal, where the external deficit was caused by a loss of competitiveness, have shown that the causes of the crisis were mainly internal to the individual countries. As a result, the solution could only be to "put your own house in order", that is change policies and regain competitiveness. From that vantage point, it was not a crisis of the euro, but rather of some countries and therefore the adjustment had to be carried out mainly by those who had accumulated imbalances (the same speech that the ant makes to the grasshopper in Aesop's fable).

A reason to intervene in support of a distressed country and to help it avoid bankruptcy is the risk that the problems will spill over to other eurozone members and threaten the strength of the currency. It was not easy to get the public to understand that what was happening in Greece, which accounts for about 2% of the eurozone GDP, or in Ireland and Portugal, could have a strong negative impact on other countries that were continuing to experience economic growth. Unlike in the United States, where the national news reaches all states and there is a single financial market, in Europe public opinion is formed in the individual countries. Rarely are people interested in what is happening in other countries. Data on the stock markets and interest rate spreads are reported by the media in countries in crisis, not in those that are performing well. It is therefore not surprising that there has not been a full awareness of the potential contagion that a crisis, even limited to a single country, could trigger for the whole EU.

The seriousness of the crisis was long underestimated partly due to the low degree of financial sophistication of the political class and European society as a whole, especially in Germany. The great distance that separates Berlin and Frankfurt, the political and financial centres, is not only geographical, but also cultural. Post-war German society does not have experience confronting financial or currency crises. The stability of the mark has long protected the real economy from fluctuations in the markets. The German economy does not have a very large financial component. Companies, especially the small and medium enterprises, which are the backbone of the system, prefer self-financing and make limited use of the stock market. Although they are savers, the Germans entrust the management of their capital above all to banks, in particular to savings banks. As a result, the German public has a limited understanding of financial markets and does not hold the banking system in high esteem, especially the international system that is held responsible for the crisis. In May 2010, Merkel, the chancellor, had to ask International Monetary Fund Managing Director Dominique Strauss-Kahn and European Central Bank President Jean-Claude Trichet to testify in the Bundestag to explain why the euro would be in danger if help was not given to Greece.

Under these conditions it was not easy for countries such as Germany or the Netherlands to understand that a financial crisis in Greece could infect the whole eurozone and endanger the single currency. Although the crisis later involved Ireland and Portugal, and then in the summer of 2011 also Italy and Spain, it was seen as a problem of a part of the currency area and not of the euro as a whole. The capital outflows from distressed countries in fact moved to eurozone countries considered by international markets to be more stable. The rise in yields on the government bonds of peripheral countries was accompanied by a reduction in the yields of German, Dutch and French bonds that were considered less risky. Despite the internal tensions, the euro remained strong and fluctuated between \$1.20 and \$1.35.

The divergence of the economic situations within the monetary union, which intensified during the crisis, strengthened the belief in

the more stable countries that the solution should take place primarily through strict measures to correct the imbalances accumulated in the countries in trouble rather than with financial help and changes to the institutions providing the framework for the euro. This belief was based on the fear that helping a country that had violated the rules, as in the case of Greece, would induce others to follow the example, thus undermining the foundation for further progress towards political unification. The experience of some virtuous countries such as Germany – which in a few years had gone from being ‘the sick man of Europe’ to being the healthiest, thanks to the reforms carried out by Chancellor Gerhard Schröder at a time of great difficulty – confirmed that putting the accounts in order while enacting structural reforms was the only sustainable way out of the crisis. If Germany had succeeded in setting things right, why couldn’t other countries do the same?

The adjustment made by Germany at the launch of the euro took place in a relatively favourable international environment. There was no global crisis at the time and international markets continued to finance public debt, which remained at low levels. Driven by emerging countries, the world economy was growing faster than 3% a year between 2002 and 2005. The German deficit exceeded 3% of GDP and its debt rose from about 60% to 68% of GDP without causing an increase in interest rates. In this context, it was possible to spread the budgetary adjustment over a longer period of time because markets allowed it.

The problem at the time was not the financial markets, but rather the rules of the Stability Pact, which do not allow a country to have a deficit of more than 3% of GDP for more than a year without incurring sanctions. The aim of these rules is to force countries to correct the excessive deficit quickly to avoid losing access to financial markets. If the markets start to waver, the effort needed for the readjustment can in fact turn out to be excessive and can cripple the real economy. At that point, it becomes necessary to resort to international aid. This is why there are institutions like the International Monetary Fund, which provides loans to distressed countries, thereby giving them support in the aftermath of a crisis.

Germany was able to obtain from the other countries a waiver for its obligations under the Stability Pact to give it more time to implement major reforms. It was a difficult decision that many later disavowed. In 2003, Germany would have had to enact a restrictive budget to return within the next year under the 3% ceiling mandated in the treaty. Given the negative growth and its reform efforts, which were undermining consensus in Germany, the German government asked to have another year before returning to below 3% so as to avoid the sanctions foreseen by the treaty. The European Commission objected, based on the principle that the rules apply to everyone, even when they are “stupid”, as Commission President Romano Prodi defined them. The Commission, nevertheless, proposed to the Council of Ministers that Germany be sanctioned. The Council, under the Italian presidency, opposed by a narrow majority and adopted an informal document in which a one-year exemption was granted to Germany to bring its deficit back below 3%.

That event was the subject of two opposing interpretations.

The first was that it was a mistake to make an exception as it set a bad example for other countries. The decision also created a rift within the EU, particularly between large and small countries. This interpretation was also adopted by the next German government, which placed the responsibility on Gerhard Schröder. This is why Germany asked to reinforce the fiscal rules when the EU bailout fund was created. The fiscal compact, approved in 2012, now makes it harder for the Council of Ministers to vote against the Commission and strengthens the automatic nature of the sanctions.

The second interpretation is more pragmatic and is based on the results obtained with that decision. Thanks to that exemption, Germany was able to consolidate its public finances and push ahead with reforms, thus becoming economically stronger. The same result might not have been obtained if Germany had been sanctioned. Maintaining that the German experience led other countries, including Greece, to adopt undisciplined public finance measures does not take into account that the Greek deficit was well beyond the mandated limit for years before Germany got the extension. What

happened in 2003, on the other hand, shows that public finances cannot be managed only with simple rules, especially in times of crisis. Rules are important, but they must be managed in accordance with specific circumstances, including the possibility of exceptions and gradual adjustments, with special monitoring procedures. However, this requires a certain amount of political judgment, which can only be achieved through greater integration of the European Union.

If this second interpretation had achieved a larger following, and the 2003 decision had been presented as a success, which it was, instead of an error, perhaps the country that drew the most benefit, Germany, would have had a different attitude during the crisis, particularly regarding the public deficits of other countries, which – with the exception of Greece – were not the cause of the crisis, but rather the symptom.

6. A MISUNDERSTOOD CRISIS

***E**ven though the euro crisis began with the destabilisation of Greek debt, public finance was not the principle cause. The impact on public accounts is a symptom of wider imbalances that had built up within the monetary union and are connected in particular to the differences in competitiveness and the fragility of the banking system. Not having understood this dragged out the crisis and led to partial solutions. Correcting public accounts is necessary, but not sufficient to overcome the crisis.*

The crisis has an origin and a global dimension. It was born from the excessive amount of debt accumulated in most advanced countries, chief among them the United States, on the basis of expectations of economic growth that proved to be too optimistic. The debt was not incurred only within individual countries, by the public and/or private sector, but also with the rest of the world. It is not a coincidence that the countries that were most affected by the crisis are those with the highest current account deficits on their balance of payments.

Historical experience shows that after a crisis caused by excessive debt, the adjustment is long and costly. An initial sharp contraction in economic activity is followed by a slow recovery that is hindered by the need to repair the balance sheets of the public and private sectors as well as those of financial institutions. In a global system, the adjustment involves all geographical areas. The eurozone has had the hardest time recovering for two main reasons. The first has to do with the accumulated internal payment imbalances. The second stems from the fragility of the banking system, which is also highly indebted. Both problems were underestimated, both before and during the crisis.

For many years it was thought that payment imbalances within a currency area were not important because in the absence of currency risk they could easily be funded. Since the launch of the

euro, many countries have financed their development, which in some cases proved to be excessive, with capital inflows from the rest of the world. Lower-income countries, such as Spain, Greece and Ireland, benefited from the fall in interest rates that came with the entry into the euro. That fostered investment also in sectors not exposed to international competition, which did not help to improve competitiveness. However, the demand for credit came mostly from the real estate sector and particularly in Spain and Ireland.

Following the launch of the euro, the labour market in many countries failed to adapt to the demands of the single currency. Salaries grew faster than productivity and were disconnected from the country's labour situation. In the ten years preceding the crisis, Italy's average productivity remained broadly unchanged while wages in the private sector rose 2.5% per year. Productivity in Germany during the same period increased 3% per year while wages grew only by about 1% per year. This reduced unit labour costs with a favourable effect on employment. The differences in the competitive positions of various countries have led to a gap in the balance of payments. Between 1999 and 2008, Italy's competitiveness relative to Germany fell more than 30% in terms of average unit labour costs. Spain lost about 40%, and Ireland and Portugal about 20%. With the loss of competitiveness and the growth of domestic demand outstripping GDP, external deficits increased. In 2007, before the outbreak of the crisis, Greece recorded an external deficit of 15% of GDP, Spain and Portugal 10% and Ireland by 5%.

With full capital mobility and a single currency, for a long time these imbalances were financed easily. In ten years, the foreign debt of Greece, Portugal and Spain rose from around 30% of GDP to 100%. Ireland went from a surplus to a net debt of more than 100% of GDP. This led many investors to believe that the imbalances within the eurozone were not a problem. They could even be justified, since some countries had to grow faster than others to close the income gap.

With the financial crisis, capital movements slowed and took more account of a country's ability to sustain its debts. The financial deleveraging prompted investors to reassess the credit risk of their

investments and reduce their exposure to the most indebted countries. The reduced capital inflows had recessionary effects and led to a deterioration of public finances.

The inability of policy-makers to understand the origins of the crisis drove them to adopt policies that were too recessionary. The recovery mainly aimed at correcting public finances, which was a symptom of the financial crisis and not the cause (with the exception of Greece). The problem was the excessive balance of payment deficit, which can be more effectively corrected with the recovery of competitiveness, which favours the resumption of exports and stimulates growth. This alternative strategy, however, depends on the ability to liberalise and reform the market for goods and labour so as to promote the growth of the sectors most exposed to international competition. The more open a country is to international trade, the easier the adjustment and recovery of competitiveness are, above all if there is economic growth in the rest of the world. This explains why, despite the sustained recovery in exports from countries such as Spain or Portugal, where that sector accounts for only a small portion of economic activity, the external deficit has been reduced much more slowly than in Ireland, which had a current account surplus already in 2010.

The difficulties in adjusting the external imbalance had a negative impact on economic growth and consequently on public finances. In fact, the greater the reduction in domestic demand needed to balance the current account, the greater the decline in tax revenues and therefore the impact on the government deficit. The fiscal crisis stems from the way in which the external imbalances were corrected, primarily through a reduction in demand rather than through a recovery of competitiveness. If the economic system had been more flexible and resilient, the fiscal adjustments would have been less recessionary. Most European governments focused on the symptoms of the crisis, imbalances in public finances, and instead ignored the causes. The reforms needed to restore competitiveness were pushed to the background and postponed, fundamentally because they required a stronger political commitment. As such, the adjustment came from the fiscal side and was more costly.

The difficulties of the banking system further contributed to disrupt the adjustment measures. In the eurozone, more than two-thirds of loans to businesses and households are provided by the banking system, twice as much as in Anglo-Saxon countries where the lion's share comes from bond markets. Taken as a whole, European banks play a much larger role in their underlying economic system than American banks do. A banking crisis can therefore produce much more serious effects in Europe. And, vice versa, a strong economic slowdown tends to weigh more on the stability of the European banking system. This makes even more significant the risk of linkage between economic and banking crises. The effectiveness of the economic adjustment thus depends on the solidity of the banking system.

European banks entered the crisis with high levels of debt that had been fuelled by the low interest rates that have long prevailed in the markets. The situation was further aggravated by the overlapping effects of the economic slowdown, the increase in public debt and the drying up of international financial markets, which together worsened the credit quality of the banks in the most negatively affected countries. The recession, which began at the end of 2008, increased the share of troubled or non-performing loans. The increase in public debt and the risk associated with government bonds made the balance sheets more fragile and weakened banks' capital base. Tensions on financial markets made it more difficult to refinance debt at sustainable rates.

Governments and regulators did not realise in time that the solution to the problem called for a rapid recapitalisation of the banking system, even with public funds if necessary. The recapitalisation should have taken place when the markets were still relatively calm, as happened in the US in 2008. This did not take place in Europe due to the political difficulty in intervening in the banking sector. In most countries public opinion is opposed to using public funds to recapitalise the banking system. The reasons are understandable given that the banks are partly responsible for the excess debt accumulated by the system, which they supplied without proper risk assessment. But this reluctance pushes political

authorities, and regulators, to minimize the problem. This was the case with the stress tests that aimed to assess the banking system's soundness and which Europe carried out only in 2010. Without decisive action, the banking system remained fragile and unable to cope with the crisis.

The uncertainty regarding the health of the banking system slowed the flow of capital to countries with external deficits and made the adjustments even more urgent. The inability of policymakers to understand the true causes of the crisis coupled with domestic political obstacles to improving competitiveness and making changes to the financial system created a situation in which the adjustment could only be done mainly through fiscal measures, which proved to be highly recessionary.

The error risks being repeated. As policy makers realise the recessionary impact of the adjustment policies that they implemented, they try to revive domestic demand through expansionary policies. These measures however create the conditions for a new widening of external imbalances, which are at the origin of the crisis. As long as it is not understood that the way to put public finances in order is by rendering the economic system more competitive, there is the risk of repeating the same error of adopting policies that curb growth and ultimately do not lead to debt reduction.

This interpretation makes it possible to understand the policy errors made in Italy over the last 20 years.

7. WITHOUT A SAFETY NET

The euro was created with the expectation, or rather the illusion, that there would never be a financial crisis. Therefore there was no need for a safety net to help distressed countries. When the crisis erupted, a quick remedy was needed, but haste is not always a good counsellor.

The rules for public finance set out in the Stability Pact were thought to be sufficient to keep government budgets in check. This is why aid to distressed countries was not foreseen except in cases of natural disasters. The Maastricht Treaty even included a clause that prohibits member countries and EU institutions from assuming the debts of others.

The reality turned out to be very different than expectations. The rules may ensure countries do not adopt overly expansive policies. But incorrect policy choices are not the only way public finances can fall into crisis; a sharp unexpected decline in economic activity that transforms private debt into public debt can have the same effect. Until the outbreak of the crisis, for example, Spain and Ireland had limited budget deficits or even surpluses. Public finances in both countries deviated from the norm only after the real estate bubble burst and brought with it devastating effects on the banking system and the real economy. The drop in tax revenue and use of public resources to recapitalise financial institutions crippled public finances. In Portugal and Italy, on the other hand, many years of weak economic growth left public finances fragile and unable to bear the impact of the crisis.

Another aspect that had been ignored at the launch of the euro was the possibility that a country struggling with its public finances could lose access to financial markets, with the result that once a country was no longer able to borrow on the markets, it would not have the resources to cover its public spending obligations (pensions,

salaries, health care costs, etc.). At this point, the crisis is no longer just about public finances but becomes economic and social.

A country in this situation is nevertheless confronted with the need to fix its public finances rapidly. If the adjustment is too abrupt, the impact on the real economy risks accentuating the recession and further increasing the public debt. On the other hand, a gradual adjustment requires the ability to obtain financing for the period necessary to complete the correction. This depends on the willingness of financial markets to continue to purchase that country's bonds. Otherwise, the country is forced to make a draconian adjustment or default on its debt. The only solution at that point is to seek help from other countries or from international institutions.

The possibility that eurozone countries could make loans to distressed countries was not foreseen when the single currency was created. It was believed that the absence of a mechanism for providing mutual help would strengthen budgetary discipline. But when fiscal problems arise from external shocks, the absence of a safety net can lead to the bankruptcy of the state with devastating effects on the economic system. In addition, when there is a clear separation between fiscal and monetary powers, as is the case with the euro, the absence of a safety net can generate fear in the markets that a temporary budget crisis can quickly turn into a problem of solvency that affects the entire country with spillover effects to the rest of the eurozone.

The International Monetary Fund does not have sufficient resources to help an industrial country, such as those in the eurozone, to cope with debt financing problems. In the case of Greece, for example, IMF rules allowed it to cover less than a third of the €110 billion provided in the first aid package. Additional funds were needed and Europe did not have a proper mechanism to meet this need.

At the outbreak of the Greek crisis, the governments of the EU countries did not realise that the problem had systemic dimensions and could only be addressed by creating a safety net. They initially worked under the illusion that the crisis could be resolved through

bilateral loans. This required the activation of budgetary procedures by the 16 countries with parliamentary ratifications that in some cases were very difficult to get. The complexity of the procedure, and its fragility, including the right of veto on the part of each country as was originally threatened in particular by Slovakia, alarmed financial markets. International investors began to doubt the ability of the euro countries to repeat the operation if another country were to find itself in difficulty. Without a permanent safety net, the EU would not have been able to help another of its members avoid default, which might have led to an exit from the euro. This explains why tensions did not decline in the days following the agreement on Greece, but rather increased.

The idea of a European Monetary Fund began to spread in the spring of 2010. Wolfgang Schäuble, the German finance minister, had been the first to launch a proposal to establish a European Fund to help distressed countries provided they followed rigorous adjustment programmes that were largely modelled on the IMF. The idea, however, was initially opposed, especially by the creditor countries and inside Germany itself.

The debate on the creation of a European Fund has pitted against each other differing views on the role of financial aid that traditionally divide Europe and explain why it is not able to speak with one voice at international organisations such as the IMF. There are two main reasons for this divergence.

The first is moral hazard, which occurs when there is an institutionalised rescue mechanism. If the safety net is too generous, it risks encouraging undisciplined behaviour. Northern European countries traditionally argue that the IMF should not be a lender of last resort to countries, because that would push them to behave recklessly with the expectation that they will be bailed out if need be. Other countries, including Anglo-Saxon ones, support the opposite view, namely that a lender of last resort that intervenes when the financial markets do not lend anymore is necessary to avoid contagion in the event of a crisis. Moral hazard can be reduced by tying financial help to a rigorous adjustment programme.

The debate has been going on for years and is repeated every time the IMF discusses proposals for new financial mechanisms or assistance to individual countries. The first group of countries is generally opposed to the creation of overly generous facilities, which are instead supported by the other countries with the intent of enhancing the ability of the IMF to intervene when there is a crisis.

The second reason for the divergence on whether to create a European Fund is linked to the different visions of the role and function of financial markets. According to the thesis often promoted by Northern European countries, the ability of a country that has lost access to international markets to return quickly to financing depends mainly on the credibility of the adjustment measures. If a country “does its homework” and “puts its house in order” it can quickly regain the confidence of the markets. In this context, making too much funding available creates an incentive to delay the adjustment and encourages countries to ask for more funding in the future. In the opposite view, markets do not behave in a linear fashion when a country is no longer able to borrow at sustainable rates and there is the risk the country will get pushed into a deflationary spiral unless it resorts to external aid. The monitoring of adjustment programmes by international institutions is needed to ensure that the loans are not disbursed unless there has been adequate progress.

These two points of view faced off also during the crisis. The creation of a European Fund requires the consent of all countries because it creates a new competency for the EU. The debate would have continued indefinitely if the crisis had not pushed governments’ backs against the wall. The European Financial Stability Facility – the so-called bailout fund – was created over the weekend of 8-9 May 2010 in the face of growing tensions in the financial markets and had an initial endowment of €440 billion. It is the core of the European safety net that was missing. The fund was however temporary and was supposed to be turned into a permanent institution within a few months.

While the crisis pushed the countries to seal the agreement quickly, the haste caused a number of problems, which were only partially resolved later.

The first problem is the decision-making procedure, which requires unanimity in deciding whether a country should receive aid. In some cases, countries asked that the vote of their representative on the board of directors of the fund be subject to a prior decision taken by the national parliament. This procedure poses a risk to the delivery of aid, especially when some parliaments ask for additional conditions, as was the case when Finland demanded guarantees in the form of collateral. The procedure creates even greater problems when the Fund intends to intervene directly in the markets for government bonds, as the speed of execution and the element of surprise is essential to ensure the effectiveness of the operation.

Northern European countries wanted the rule on unanimity for fear of being outvoted by the debtor countries, which if they were in greater numbers could get together to water down the conditions for the delivery of financial aid. In effect, it is not sound management principle to have the majority of votes in a cooperative-type institution in the hands of borrowers. However, it would have been more effective to establish thresholds for qualified majority voting so as to give more power to the creditor countries without risking a paralysis by giving all a veto power.

The result is somewhat paradoxical. A eurozone country's request for financial aid goes before two institutions: the International Monetary Fund where it is decided by majority voting and where European countries have only 20% of the votes, and the European Fund where decisions are adopted only after a unanimous vote by eurozone countries.

The second problem concerns the conditions for granting the loans, which were initially inspired by the praxis used by the International Monetary Fund and did not take into consideration the specificity of the monetary union. It became clear from the beginning that the interest rates on the loans were too burdensome and repayment deadlines too quick, especially for countries that cannot

devalue their currency. Only after long negotiations were the conditions revised and made less onerous.

The last problem is the relatively small size of the fund's available capital. The interventions to help Ireland and Portugal almost halved the fund's resources. The remainder is not sufficient to deal with requests from larger countries such as Spain or Italy. This fuelled concerns in financial markets that the euro did not have enough resources to help all the countries in distress and avoid contagion. Only a very large fund – the so-called 'bazooka' as US Treasury Secretary Hank Paulson called it – would calm the markets.

The fund's resources are limited by the fact that it is financed by countries that do not request aid. The greater the number of debtor countries, the greater the portion that must be paid by the creditor countries that remain. A fund that is too large can deliver more resources, but the burden falls on a limited number of solid countries putting at risk their financial stability.

Various proposals were examined to try and increase the capacity to intervene without boosting the resources. One hypothesis was to use the initial allocation of funds as capital in order to gain financing through the European Central Bank using securities purchased on the market as collateral. Another option discussed was to use the funds to guarantee a part of the losses sustained by investors, thus boosting the amount of securities that could benefit from the guarantee.

These proposals were discarded due to the opposition of the creditor countries that saw them as a way to increase the total credit exposure beyond what had been decided by the respective countries and parliaments. The German Constitutional Court, in particular, pointed out that any increase in the risk assumed by the fund that had to be paid by Germany would always have to be approved by the German parliament.

The stability mechanism's endowment can only be increased by a unanimous decision of the member states. Whenever the discussion came up about the need to increase the size of the fund, the creditor countries maintained that the funds already approved had to be used up before it could be augmented. The fear that too big of a fund

would encourage undisciplined behaviour prevailed here as well. While this is an understandable position, it creates the fear in the markets that when the need to increase the size of the fund emerges a country will use its veto.

One of the key aspects of the mechanism concerns how a country's share of the fund is decided. The size of each country's contribution is calculated in the same way as with the ECB and is based on the GDP and population of the various countries. Germany is the largest shareholder, with 27%, followed by France with 20.3%, Italy with 17.7% and Spain with 11.9%. During the crisis some observers suggested the system was distorted in favour of Germany and France, the two banking systems most exposed to Greece, and therefore the fund had to be redesigned to take into account the credit positions of the respective countries. That proposal is impractical and counterproductive for a country like Italy that depends on external credit and is vulnerable to contagion coming from other countries affected by a crisis. This is certainly at odds with the practices of major international institutions such as the IMF and the World Bank that provide aid to countries in need that is not dependent on who paid into the system. Implementing variable amounts depending on the countries being helped would be difficult and would remove certainty from the system. Moreover, this proposal does not take into account the fact that the principal holder of the government bonds of the European countries in crisis is their respective domestic financial system. Finally, this system would encourage the national authorities of the creditor countries to put pressure on their banking systems to avoid lending to debtor countries, thus reducing the degree of market integration at the expense of countries such as Italy that need to borrow extensively in the markets.

The creation of the bailout fund in May 2010, however, did stabilise the markets. That is, until it was decided to turn the fund into a permanent institution.

8. HOW TO HURT YOURSELF

Searching for the best option often leads to missing out on a good option. Without a crisis, change does not occur, and yet crises are often not the best time to change the institutional framework. The European bailout fund was modelled on the International Monetary Fund, but with some important differences that played a role in aggravating the crisis.

Creating the bailout fund in the midst of the crisis triggered two types of problems. The first concerns the violation of the rule set out in the Treaty on European Union (known as the Maastricht Treaty) that prohibits countries from assuming the debts of others (no bailouts). This clause was considered essential by the countries with traditionally stronger currencies before they would adhere to the euro. In Germany, where the population was reluctant to abandon the Deutsch Mark, Helmut Kohl, the Chancellor at the time, was able to convince parliament to ratify the treaty because of the inclusion of this rule. Germany's main fear was that the monetary union would become a 'transfer union' in which the more fiscally disciplined countries would transfer resources to the undisciplined ones, as has happened in Italy with large transfers to the south and in Germany to the east.

The bailout fund is compatible with the treaty, something the German Constitutional Court has also recognised, because though it allows loans to be made it prohibits paying off the debts of other countries. A loan is not a transfer of resources if it is refunded. The bailout fund intervenes as the IMF does, making loans to countries in need offering them lower interest rates than the market would offer and longer maturities in exchange for an adjustment programme that if fully implemented can restore the confidence of the markets and attract new private funding.

Aid to Greece in the form of a loan with conditions similar to those made by the IMF is not a transfer of resources and therefore is not prohibited by the treaty. It would be prohibited only if Greece does not repay the loan. At that point, the taxpayers of the creditor countries would effectively have to assume the Greek debt thereby flouting the ban.

How can one be sure that countries that accept loans from the fund will repay them? One way is to give the bailout fund privileged status, such as that enjoyed by the IMF, which guarantees repayment priority over earlier loans. This privilege is justified by the fact that the IMF intervenes when other potential creditors are no longer willing to finance the country. A creditor that intervenes last takes on more risks and therefore must be protected, above all in the case that the debtor is unable to repay all the debt and must restructure or default. When the bailout fund was established in the spring of 2010, the IMF opposed the extension of privileged status to other institutions because the more privileged creditors there are the harder it is to safeguard that privilege in the case of a debt restructuring. The May 2010 agreement established that the bailout fund would not have a statute comparable to that of existing international institutions.

In the process of being ratified by the national parliaments in the summer of 2010 and in the discussion surrounding the transformation of the fund into an EU institution established by treaty, many countries voiced their concern that without privileged status the loans granted by the fund could easily end up being restructured with taxpayers absorbing the losses. Without privileged status, creditor countries would have reduced the amount of funds they made available and the mandated adjustment conditions for distressed countries would be more stringent. These considerations led member countries to change the bailout fund, giving it preferential status similar to that of the IMF, despite the IMF's opposition.

The evolution of the crisis has shown, however, that this privilege can become a problem. In fact, if the crisis worsens and a country is unable to meet its debt obligations and must restructure to

reduce the value of the debt, the 'haircut' made to loans held by non-preferential creditors is all the larger the bigger the share of debt held by privileged creditors. In other words, the higher the share of 'privileged' debt the more drastic the restructuring of the debt held by private non-privileged investors will have to be.

Private investors therefore have the incentive to sell their remaining securities and not renew funding. This creates the paradox that without special treatment the official lenders are reluctant to intervene, but the help of official creditors that enjoy preferential treatment tends to discourage private creditors. The political objective of encouraging other EU members to come to the aid of distressed countries by protecting their loans comes into conflict with the goal of restoring market stability and encouraging private lenders to continue funding the troubled countries.

The issue arose in the case of Greece when in 2011 creditor countries were asked to grant new aid that would cover up to two-thirds of Greece's total debt, leaving only a third to private creditors. This triggered a massive sale of Greek bonds as investors feared they would be harder hit by a possible debt restructuring. The contagion effect on the system was immediate.

The ECB, which had bought Greek bonds as part of its market interventions started in May 2010, also demanded preferred creditor status - refusing to incur losses in the event of a Greek debt restructuring. This further reduced the share of private creditors who shouldered the burden of the restructuring. On the other hand, any loss would have forced the ECB to boost its capital base by using public funds. This would have amounted to an indirect transfer of taxpayers' money to Greece. The central bank would have been exposed to the criticism that its intervention sought to finance Greek debt rather than stabilise the markets and improve the transmission mechanism of monetary policy. This would have compromised the central bank's ability to intervene in a similar fashion in the future.

The ECB's bond-buying programme has drawn criticism in several countries, particularly in Germany, as it may provide an indirect way to side-step the ban on financing state debt. The criticism is based on the assumption that the price at which a bond

can be purchased on the market does not necessarily reflect the associated risk and that losses can be higher than expected, in which case it would be a transfer of resources among the member states that are ECB shareholders. Given such concerns, the ECB would have larger scope for action if it had privileged status and was thus shielded from incurring losses arising from its actions.

This is why in October 2012 EU countries opposed an IMF proposal to restructure official aid granted to Greece. This would have made the debt burden more sustainable, but it also would have hit creditor countries' taxpayers thereby showing that the loans were effectively direct transfers and hence in violation of the treaty. This would have stirred strong negative reactions among the public and reduced the scope for future use of the bailout fund.

The conditions imposed by political considerations in order to launch the bailout fund have triggered a short circuit between official aid and private funding. Far from acting as a catalyst – reassuring markets and attracting fresh funds – support from European institutions has spooked investors delaying a bailed-out country's return to the markets. This has increased the likelihood of a debt restructuring and discouraged the offer of new aid unless creditor countries were protected by preferred status in the case of a restructuring.

This downward spiral destabilised financial markets beginning in the spring of 2011, when talks on a second aid package for Greece began, until the autumn of 2012, when the aid package was finalised with a third debt restructuring in just over a year. European institutions continued to insist that the Greek case was unique, but uncertainty on the markets did not keep the contagion from spreading to other countries.

Given the large share of Greek debt now held by other European countries, it is inevitable that at some point a restructuring will have to be taken into consideration also for that part. There are precedents within the Paris Club involving in particular poor countries or Eastern European countries following the fall of the Berlin Wall. To be politically palatable for creditor countries to accept a restructuring, they must first see significant progress in Greece's

economic adjustment programme. To not run aground of the norms in the treaty (no bailouts), the operation will also have to aim to lengthen the maturity of the loans and lower interest rates to the level the IMF charges poor countries.

The bailout fund's second problem concerns the private creditors' involvement in the resolution of a financial crisis. National parliaments, especially Germany's, called to ratify the accord on the fund voiced concerns that resources would be used to repay private creditors, specifically large international banks, that had made reckless investments. In theory, when taxpayer money is being used to help a country, private investors should also take part in the bailout by accepting a haircut on their bonds. This idea, championed by Germany, translated into a request to tie the fund's help provided to a troubled country to a restructuring of the recipient's debts held by private creditors.

To tie together financial aid and a restructuring may appear only fair. The greater the loss inflicted on private investors with the restructuring, the smaller the aid other countries' taxpayers must provide. However, in the midst of a financial crisis, a proposal of this kind cannot but upset international markets. Whenever the International Monetary Fund helped a distressed country after World War II it would contemplate the possibility of a debt restructuring only in extreme cases – when it was clear that the debt was not sustainable. Such extreme cases have been very rare. As long as the debt is sustainable, a restructuring is not necessary as the help of international institutions can spread out the necessary adjustment over a longer period and encourage the return of private lenders.

Tying the aid provided by the bailout fund to a restructuring of the debt, regardless of whether it may be sustainable, pushes private investors to dump the assets of a country at the first sign of trouble. The prospect of the Fund getting involved destabilises markets because it causes the value of private investments to fall. The crisis thus intensifies, taking away any positive impact of the decision to help a distressed country through public funds and an adjustment programme.

Having private creditors shoulder some of the losses became a concrete reality in the agreement that Germany and France reached at Deauville in mid-October 2010. To give a green light to the final version of the bailout fund, Germany wanted stronger budgetary discipline, giving the EU Commission more control over national budgets. France was against it. During a walk on the beach at Deauville, French President Nicolas Sarkozy gave into the German request of private sector involvement in exchange for the German chancellor dropping her demand that the Commission be given more powers over national budgets. A few days later the bilateral agreement was accepted by the heads of state of the other euro members during a tumultuous summit.

However, it was not the governments of the other eurozone countries that put up resistance – they were only too happy not to give the EU Commission more powers – but rather the ECB. Jean-Claude Trichet, president of the ECB, on several occasions at the summit warned the governments of the effects that the clause on private sector involvement would have on financial markets. International investors would immediately cut their holdings of euro-denominated assets, especially those made in the weakest countries, for fear of being dragged into a pre-emptive debt restructuring. During the Deauville summit Sarkozy severely reproached Trichet for opposing a political accord reached at the highest level that could not be obstructed by the central bank. It was the governments, and not the ECB, that saved the euro in the spring of 2010, Sarkozy said. Since it was taxpayers' money, governments were responsible for any decision and the ECB could not oppose it. No one sided with Trichet, not even the representatives of those countries that were most exposed to a possible negative market reaction. Herman Van Rompuy, the President of the European Council and an economist by training, understood the problem but lacked the courage to support Trichet.

In the press conference that followed the summit, Sarkozy told reporters of the decision regarding the involvement of the private sector in the crisis resolution and also mentioned Trichet's opposition, boasting of "the victory of politics over technocracy". It

took only a few minutes for financial markets to grasp the scope of the deal and begin selling in bulk euro-denominated bonds, especially Greek, Irish and Portuguese, as well as those of other countries seen as potentially weak. Interest rates started rising again undoing the stabilisation effect of the massive interventions carried out by the ECB after May 2010. Trichet returned to Frankfurt saying: “they stabbed us in the back”.

Sarkozy and the leaders soon realised they had made a mistake. But it was politically difficult at that point to change path and convince national parliaments and the public that the agreement caused huge damage. Some, such as German Finance Minister Schäuble, tried to soothe markets by pointing out that the rule on the involvement of private creditors would come into force only in 2013, with the final version of the bailout fund, but his comments backfired. Financial markets base investment decisions on future events so the coming into force of the rule in 2013 would hit any bonds maturing after that date, and therefore a big chunk of Greece’s debt.

Without openly breaking with Angela Merkel for fear that a public disagreement with Germany would also penalise French bonds, Sarkozy told his representatives who were supposed to conclude the agreement at the technical meetings to discuss some aspects of the accord so as to obtain the consent of the central bank. After long and exhausting negotiations between the central bank and Germany, with France between the two, the October 2010 agreement was modified two months later. The European Council’s conclusions of December 2010 diluted the provision on private sector involvement in financial crises. An explicit reference was added saying the bailout fund would follow the same procedures of the IMF in which the involvement of the private sector is not automatic and is foreseen only in extreme cases of insolvency.

The ECB’s demands had been accepted, but the damage was not easily repaired. The suspicion that European countries would now be able to restructure their debts more easily than under the current praxis had crept into financial markets. The flight from riskier assets was further favoured by a media campaign – fuelled by

academics, commentators, and in some cases also by market participants sometimes with an obvious conflict of interest - to support an 'orderly' debt restructuring, as if such a theoretical concept was feasible in practice. It was a costly illusion.

9. THERE ARE NO PAINLESS CURES

***T**here are three ways to reduce excessive debt: a restructuring that reduces its nominal value, a reduction in its real value through inflation and a budget tightening that over time reduces its weight relative to output. The first seems to be the easiest and least painful: reduce the debt and start over, just as a company in financial difficulty might do. But countries are not companies.*

Since the beginning of the crisis, financial markets have called into question the ability of some countries to support the debt they accumulated over the years. The solvency of a country is different from that of a company or a bank. A country is solvent not only if it has the capacity to pay, it must also have the will.

When the situation in Greece began to deteriorate in the spring of 2010 a debate started about whether to restore the sustainability of public finances with extraordinary restructurings. The choice of whether to enact this type of intervention depends on the comparison between the effects on the financial and economic systems and the social and political cost of implementing protracted austerity policies. The strongly recessionary effects of the Greek adjustment programme led some commentators to conclude that a debt restructuring would probably have been less costly. In its ex post evaluation of the Greek programme, the IMF suggests that debt restructuring should have been implemented earlier, since May 2010. This position was based on the idea that it was possible to arrange a relatively painless and effective debt restructuring.

A debt restructuring entails exchanging existing securities with new ones that have a longer maturity and/or a lower interest rate. The lower value of the new securities saddles investors with a capital loss. The transaction can be imposed by a unilateral decision of the issuer that will trigger numerous lawsuits, especially on the part of

international investors, or on a voluntary basis through an exchange of securities.

The question to ask is why an investor holding a government bond would accept to exchange it for one with a lower value. The answer is that without the exchange the debt is unsustainable and the value of the bonds could decrease further. The exchange is effective if the vast majority of creditors agrees to the terms and if the reduction in value makes the new stock of debt sustainable. This type of operation is extremely complex. The individual investor is incentivised not to accept the exchange and to keep the old securities in the hope that the operation is successful thanks to the participation of other investors thus allowing the state to repay all the bonds, including those that have not been exchanged. If everybody does this, however, the voluntary restructuring fails, which is why this type of operation must be strongly encouraged by the authorities as part of an agreement with the principal investors.

There are not many cases of an orderly debt restructuring. Uruguay in 2002 is generally held up as a model. Following the contagion from the Argentine default, Uruguay suffered a liquidity crisis when markets were no longer willing to refinance foreign debt. The Uruguayan government however was able with the help of the IMF to negotiate with the creditors a lengthening of maturities, limiting the effective loss to about 11% of the value of the securities.

In most other cases, such as Argentina in 2001, the reductions in the value of the bonds needed to make the debt sustainable are much more drastic and the losses the creditors are forced to absorb make it difficult to implement the exchange on a voluntary basis. If the restructuring is forced on investors it invariably will trigger fights, especially with international investors, and lawsuits that drag on for years. The country loses access to markets and risks having to live in autarky, as happened with Argentina.

Another often-cited example is Iceland in 2008 where banks were allowed not to repay their debts to foreign investors while at the same time they honoured their obligations to residents. This type of operation is not replicable in the European Union where the rules of the internal market do not allow countries to treat their citizens

preferentially compared those of other member countries. Banks and European countries cannot fully repay their debts to residents while restructuring only the debt held by foreigners. This is why it was not possible in the eurozone to seek a solution similar to that of Iceland.

A forced debt restructuring, or one that is strongly encouraged, triggers chain reactions in the markets and contagion that transform a local event into a systemic crisis. The first type of contagion comes from the collection of insurance purchased to protect against the effects of a restructuring (credit default swaps). Financial institutions that sold these securities immediately find themselves in difficulty and some may fail. The failure of Lehman Brothers in September 2008 immediately triggered protection contracts that had been sold by insurance companies, in particular American Investment Group (AIG), causing them to collapse. To avoid contagion, the American taxpayers had to allocate much more funds than would have been necessary to save Lehman Brothers.

The second type of contagion comes from the standard market reaction after a restructuring, which pushes market participants to question what other countries could follow the same path. The flow of investment to these countries immediately drops, driving up interest rates and further threatening debt sustainability. Financial markets have experienced this type of contagion since the end of 2010. This was also one of the reasons why the rating agencies reduced the credit rating of some European countries. Whenever fears about the restructuring of Greek debt surfaced, immediately interest rates on government bonds rose, not only on Greek bonds, but also on those of the other weak countries that were under the markets' spotlight. In the spring of 2011, when the idea of a Greek debt restructuring began to take shape, investors begun dumping the securities of other countries considered to be vulnerable to a restructuring and moved their money into lower-risk assets. The restructuring, agreed to at the European Council meeting in June 2011, included a voluntary exchange with the major banks holding Greek debt and led to an effective reduction in value of just over 20%. The market reacted negatively because the operation was not sufficient to re-establish the sustainability of Greek debt, and, in fact,

a new restructuring would be necessary a short time later. The interest rates of all distressed countries began to rise beginning in July 2011 with contagion to Italy and Spain happening at this time.

These mechanisms explain why the problems of a country that accounts for little more than 2% of the eurozone GDP led to a massive crisis that even called into question the euro's very existence.

The most important – and often underestimated – effect of a debt restructuring is not so much on the international markets, but rather on the country's financial system itself. When a substantial part of the debt is held by domestic investors, the consequences of a restructuring affect mainly the citizens of the country involved. Since government bonds are a savings instruments typically used by the weaker and less financially sophisticated part of the population, a restructuring may cause unpredictable consequences for social cohesion. Confidence in the state is seriously undermined with a chain reaction of destabilising events. It is no coincidence that the restructurings of public debt rarely occur in countries that are democratic or remain democratic.

The banking system, one of the main investors in government bonds, is the first to be affected by a restructuring of public debt. The banking system risks collapsing if losses are not offset through a capital injection. However, a country that restructures its debt does not have enough funds to strengthen the balance sheet of its banks. Debt restructuring ends up crippling the financial system and carrying the real economy down with it. The only way to raise new funds is to ask the international community for help.

Without external assistance to recapitalise the financial system and allow the state to continue making payments, participation in the single currency is put in jeopardy. The risk of a debt default becomes the risk of leaving the euro. The hypothesis of a 'Grexit' (Greek exit) spread through the markets in spring 2011 in connection with the Greek debt restructuring and the continuing difficulties of the other eurozone countries to agree on aid to Greece.

A debt restructuring does not solve an economy's underlying problems, in particular the lack of competitiveness and low growth

potential. The risk is that, as happened in the case of Argentina, the restructuring creates the illusion of having solved the public finance problems and leads to a delay in the implementation of the reforms needed to treat the underlying problems that led to the unsustainable debt load. This is precisely what happened in Greece. The hypothesis of a debt restructuring began to circulate in early 2011 with the emergence of the first political difficulties in the implementation of the adjustment programme, especially with regard to structural reforms and privatisations. The Greek authorities began to consider the possibility of a debt restructuring in the hope that this would allow them to ease the adjustment. This created an unholy alliance between opposing political interests – Greece and Germany. On the German side, the government did not feel it could ask parliament for a second bailout package without a debt restructuring and the involvement of private investors. The fact that the banks would have contributed to the restructuring made it more acceptable to ask for more public funds to help Greece.

From the political point of view the exchange seemed like a good idea, but it omitted a crucial aspect. Much of the Greek debt was not held by foreign banks, but rather by Greek banks. The largest losses in the event of a restructuring would have been sustained in Greece. To avoid the collapse of the country's financial system additional help was therefore necessary. The savings from the restructuring of the debt would be largely offset by the increased funds needed to recapitalise the Greek banking system.

The domestic political objectives of the two countries prevailed and there was no opposition from other governments, not even those most likely to suffer contagion. Only the European Central Bank opposed a forced restructuring and asked governments to negotiate an appropriate reduction in the value of securities with private investors that would allow Greece to restore its debt sustainability without triggering excessive contagion effects. This proved not to be possible. The agreement, reached in extremis at a European Council meeting in June 2011, was too favourable to private creditors. The interest rate on new Greek bonds increased right after the exchange,

indicating the expectation that a new restructuring would soon follow.

Another important lesson that should have been learned from previous experiences had been forgotten. A debt restructuring never happens in a single stage, but is rather a series of successive operations that lead to unstable market conditions for a long time. For international investors the Greek operation marked the first case of a debt restructuring by a Eurozone country. The risk of further losses not only on Greek debt, but also in other countries, had become real. The European Council stated officially that the Greek case was unique and there would be no other restructurings, but the market did not believe it.

As expected, the effects of the restructuring proved to be damaging, also in political terms. The reduction of Greece's debt load did not solve any of the country's problems. Indeed, the political situation worsened up to the 2012 elections. European partners' confidence in Greece, which was already low, fell further. Financial markets got jumpy and for a long time considered the collapse of the euro a real possibility.

10. THE GAME OF 'CHICKEN'

*I*n the film "Rebel without a Cause" James Dean and another boy drive their cars toward a cliff to show the girls how courageous they are. Whoever swerves first loses and appears weak. However, if nobody swerves as they both wait for the other to do it first, then they both die. The 'chicken' is the one who swerves first. This dynamic is used in game theory to explain the interaction between investors, countries and institutions. It helps explain many actions taken during the crisis.

The game ends well if one of the two players manages to convince the other that he will not back down at any price and the other adapts to avoid dying. The game ends badly if those who say they will not back down are not credible or if there is an unexpected event as is the case of the film.

The game can also end badly in real life. When Dick Fuld, the head of Lehman Brothers, realised that what he had heard repeated for days from the US Treasury Secretary Hank Paulson was true, namely that the US government would not use public funds to save the bank, he understood that his bluff had not worked and he no longer had time to find a buyer. He had held out thinking that eventually Paulson would back down, given that the cost of rescuing Lehman would have been well below the consequences of failure on financial markets and the US economy. Paulson did not have the funds to save Lehman. He had repeatedly said this publicly, but Fuld had not believed him. This is a typical case in which the game of chicken ends badly.

During the euro crisis, the interaction between the authorities in different countries took on characteristics similar to the game of chicken. In discussions with its European partners, the Greek government was fully aware that the country's exit from the euro would have enormous costs for the Greek economy, but also for the rest of the EU. Greek authorities knew that the European institutions

had an interest in avoiding that Greece would leave the single currency. This prompted the Greek government on several occasions to try to renegotiate the terms of the bailout agreement in a bid to get additional aid even though it had not fully implemented the measures foreseen in the adjustment programme. The European institutions, for their part, knew Greece would bear the brunt of the cost of its exit, but they were also aware that the contagion would hit other euro countries and they therefore had an interest in granting more aid to avoid Greece's exit.

If chicken had been played only once, Greece would most likely have won. It would have obtained more aid on more favourable terms and a longer period of time to implement the restructuring. And in fact, in the early months of the adjustment programme, Greece was able to obtain a relaxation of the conditions it was supposed to fulfil to receive disbursements from the European Union and the International Monetary Fund. The problem arose when the negotiation was repeated. At that point the decision was no longer dependent only on the costs and benefits of the individual choice but also on the impact that the choice would have for the future credibility of the strategy. Each time a player loses because he yields before the other it becomes less credible that he will change strategy in the future, and thus win. Each time the European institutions gave into Greece's requests, granting more aid with less restrictive conditions, the expectation that they would give in again the next time increased. The Greek government thus had the incentive to ask repeatedly for further extensions, postponing the measures called for by the adjustment programme.

This is the moral hazard problem, which occurs when an action generates the expectation that it will be repeated systematically in the future. In this context, a choice that seems optimal in the short term becomes counterproductive because it creates perverse incentives in the medium term. This is why the economic policy cannot be subjected to too much discretion and should preferably be subject to rules, even if those rules may appear too rigid when the effect is evaluated on a case by case basis.

In the face of repeated Greek requests for more aid and to postpone the measures agreed in the programme, the EU institutions had to become more rigid in defending their position, in particular in 2012 at the time of the election. To persuade Greek authorities and the country's public that the programme agreed with the international institutions had to be implemented, European leaders came close to threatening to let Greece leave the euro. During the summer of 2012, Eurogroup President Jean-Claude Juncker and others caused further tensions in the markets by publicly stating that Greece's exit was not ruled out. Only then did the new Greek government and the parties that supported it understand that the European institutions would not continue to give into the demands that the programme be diluted.

Unlike Fuld, Antonis Samaras, the Greek Prime Minister who emerged from the June 2012 elections, realised it was no longer a good idea to test the determination of the European authorities and its strategy, deciding to put into action the agreed to programme. Two years of publicly going back and forth in clear view of the financial markets created considerable uncertainty regarding the capability of the EU institutions to resolve the crisis.

Countries were not the only ones to play chicken. European institutions also played among themselves, in particular the European Central Bank against the European Council. The most noteworthy case was the creation of the bailout fund in the spring of 2010. In the first week of May, tensions in the financial markets had not subsided despite the agreement reached on the financial support for Greece. The lengthy process and the political difficulties in reaching the agreement on the fund stoked doubts in financial markets that the same type of operation could be repeated if the crisis spread to other countries. Without a mechanism to help distressed countries, it was feared there would be neither the funds nor the political will to save another country – as happened in the United States when after the rescue of the first investment bank, Bear Stearns, there was no appetite to save also Lehman Brothers.

The only way to calm the markets and convince them that the European countries were determined to avoid a new crisis was to

institutionalise the mechanism put in place to aid Greece and provide it with sufficient funds. The crisis was rapidly worsening and there was little time to reach a deal. An intervention by the European Central Bank would have been able to reduce tensions and buy time to allow the countries to reach an agreement. If the bank had decided to buy securities of the distressed countries on the market, interest rates and the spreads would have been reduced rapidly thus calming markets. At that point, however, the pressure on governments to establish the bailout fund rapidly would have diminished. The central bank would have found itself in the position of having to intervene for a long period of time without having any leverage on governments to find a definitive solution quickly. The intervention would push monetary policy into the area of budgetary policy with potentially distorting effects on the markets and threats to the independence of the central bank itself. On the other hand, even if the fund was created quickly, the practical implementation would take time during which the markets would still have to be kept at bay.

European governments were confident, therefore, that the European Central Bank would not let the markets collapse. It was widely expected that the intervention could be carried out even without a prior agreement among the governments. To bring the governments back to reality, the president of the central bank on 6 May 2010 had to intervene publicly to say that the bank would not act before the governments had taken the decision to create the fund. The European Council decided on 7 May to establish the bailout fund. The European Central Bank intervened on the markets on Monday 10 May after the finance ministers had completed the details of the deal.

In order to be believed by the governments, the central bank had to express publicly that it was against a preventive intervention. The strong negative reaction of the market pushed the governments to reach an agreement. The institutional step forward came when it became clear what the consequences of a failure would be. Only at the edge of the cliff and without the protection of the central bank did the governments decide to act.

The game of chicken can be destabilising if it is played between countries and institutions in front of the financial markets, which become an active player in the game. Experience shows, however, that this is perhaps the only way to push governments to act in times of crisis.

11. THE PRICE OF PRIDE

Governments try to confront crises on their own for fear that a request for help from international institutions will lead to a loss of sovereignty. Aid is therefore requested at the last minute when the pressure from financial markets can no longer be contained. At that point, the situation is compromised and the measures necessary to stabilise the markets must be much more drastic, and painful.

The tendency to minimise the difficulties and postpone the request for external aid was apparent with Greece, which in the early months of 2010 despite the rapid deterioration of its financial situation continued to defer the request for aid. The postponement was also encouraged by the German government of Angela Merkel, who did not want to present the matter to the German parliament before the regional elections in North Rhine-Westphalia. On March 8th, six weeks before Greece's official request for aid, George Papandreu, then Greek Prime Minister, and Angela Merkel declared in a joint press conference that "Greece will not require any financial aid" and "Greece doesn't need help." To deny the reality was one of the recurrent themes of political institutions during the crisis.

The request for aid was finally advanced in May after Greece had lost access to financial markets and interest rates on its debt had risen to unsustainable levels.

Ireland went down the same road. The request to the IMF and the EU for aid was made only in late November 2010, after months of negative data on public finances and growing worries about the Irish banking system. In Portugal, the government tried to postpone the request for aid until after the elections scheduled for June 2011, but the deterioration in market conditions did not allow for the delay. All the main parties signed the aid programme before the election.

The reluctance of governments to seek financial support from international institutions until they are basically obligated to do so can be explained in two ways. The first is political. By asking for external help, a government is acknowledging in front of parliament and the public its inability to solve the country's problems on its own. Governments requesting outside aid rarely survive the next election. This is confirmed by events in Greece and Ireland, where the governments that signed the programme lost the subsequent elections. It is unclear, however, whether the negative perception of the voters is due to the request itself or the policies that led to the need to request aid. Moreover, the tendency of governments in power to lose elections is very widespread in Europe and not only in the countries that requested aid from international institutions.

The second reason outside help is refused or delayed is because it involves accepting measures to restructure the budget and structural reforms that are seen as external impositions and are interpreted as a loss of sovereignty that humiliates the country.

In reality, the economic policy measures contained in the adjustment programme are needed in any event to reduce imbalances and regain credibility on the markets. They are accompanied by financial aid that reduces the cost of external financing and allows the pain of the adjustment to be diluted over time. They also help restore a climate of confidence in the markets and attract new capital. This is the experience of most countries that in the past, sometimes even against their will, have turned to the International Monetary Fund for aid. Over the last 15 years, countries such as Brazil, South Korea, Turkey and Indonesia received help from the IMF, through which they restored the health of their economies that have since become among the most solid and fastest growing in the world. There are, of course, exceptions such as Argentina, although the country at a certain point decided to stop the IMF's programme and defaulted.

A country may also try to convince the markets of its solvency without recourse to external aid. But it must act quickly with credible measures that have immediate effects on the imbalances accumulated over time. The more actions are delayed, the more

investors are likely to lose confidence and the more drastic are the measures that have to be taken. When markets lose confidence it takes a long time to get it back and in the meantime the financing costs increase making the adjustment more painful.

In summary, although a call for external aid signals the inability of the ruling political class to solve the country's problems, not asking for help imposes a significant cost on the economic system.

In September 2011, with Italy having trouble adopting measures for a credible restructuring, in particular regarding structural reforms, the IMF offered the country a precautionary type of programme of financial aid with soft conditionality and the availability of financial resources to confront the risk of the instability of the government bonds. The Italian government refused, concerned about the political cost to be paid for accepting help from the International Monetary Fund a year and a half before elections. Markets reacted negatively, interpreting the rejection as confirmation of the country's inability to take the necessary steps to rectify the situation. The refusal did not help the government headed by Silvio Berlusconi, who resigned a few weeks later to make way for a new government headed by Mario Monti, whose restructuring programme had to be even more drastic than what the international community would have accepted just a few weeks before.

The second reason why countries tend to avoid turning to external aid is that financial markets do not always react favourably to the request. In the case of Greece, Ireland and Portugal, the financial conditions worsened immediately after the request for aid, interest rates increased and access to international credit became virtually impossible. The aid basically had to cover the entire financial needs of the countries for a couple of years with disbursements on an unprecedented scale.

In Ireland's case, interest rates rose precipitously in 2011 after the country entered the programme and began to decline only in 2012, returning progressively to levels below those prevailing before the acceptance of aid. One of the causes was also connected to the contagion of the debt restructuring. The experience of Greece, which restructured its debt twice at a cost to private creditors of more than

70%, led the market to believe that such a big 'haircut' might also be carried out in other countries. The delay with which countries asked for aid exacerbated the market conditions.

The ECB's decision on 6 September 2012 to prepare a programme of open market transactions (OMT) to buy government bonds, potentially in large quantities, to reduce the risk of an exit from the euro, increased the benefits a country can enjoy from an adjustment programme agreed with the IMF and the European Union. In fact, the effectiveness of measures taken to adjust public budgets depends also on other economic policies, in particular monetary policy. As textbooks point out, to be sustainable a restrictive fiscal policy must be accompanied by an accommodative monetary policy that translates into lower interest rates not only for the public sector, but also the private sector. In the European context, a country that does not resort to external aid because it refuses the conditionality cannot fully benefit from the expansionary monetary policy implemented by the central bank.

Without the benefit of low interest rates and an expansionary monetary policy, fiscal tightening risks making things worse. The problem comes not only from the interest on the public debt, measured by the so-called 'spread', but also the negative effect produced by the high interest rates on the conditions under which bank credit is granted to the private sector. Monetary conditions that are too restrictive frustrate the fiscal adjustment.

Nevertheless, countries such as Italy or Spain - which even after the ECB's September 2012 announcement continued to have interest rates that were higher than those in other eurozone states - did not ask for help from international institutions as they sought to make the adjustments on their own. The political cost for the government in office was evidently considered higher than the advantage of a lower interest rate, which would surely have benefited the economy. In the Italian case, the adoption of an adjustment programme signed by all parties before the February 2013 elections, as happened in Portugal in 2011, might have reduced political uncertainty.

One must reflect on the need to reduce the incentives governments have to delay the request for aid, which entails significant costs for the system and risks spreading contagion to other countries in need. One way would be to create a system of automatic aid that kicks in when the interest rate differential (spread) exceeds a certain threshold. The mechanism could be similar to that provided in the treaty for the excessive deficit procedure that is triggered when the deficit exceeds 3% of gross domestic product. In this case, a country would begin a programme, possibly also as a precaution, when the differential on interest rates exceeds a predetermined level, for example 200 basis points, which is also the threshold for evaluating the degree of convergence of a country that is seeking to join the euro. If a country is not allowed to join the euro with a yield differential of more than 200 basis points, neither should it, once within the single currency, be able to hit such a large spread without having to adopt corrective measures.

The adoption of fiscal and economic measures agreed with European or international institutions should not be demonised. Membership in the single currency entails in itself a loss – or a sharing – of sovereignty, including on public finances. EU rules already obligate countries to submit annually a stability programme to show that their multi-year budgetary plans are consistent with the 3% limit set on budget deficits. If they breach the limit they are subjected to strict monitoring procedures. The fiscal compact rules adopted in 2012 further strengthened EU procedures by reducing the room for manoeuvre that countries have over their budgetary policies.

Structural reforms are the main sticking point when comparing existing procedures to an adjustment programme agreed with the European Union. These measures are the competency of member states and there are no binding mechanisms comparable to those that apply to national budgets. A mechanism of heightened macroeconomic surveillance was agreed at the end of 2011. Based on structural indicators, it aims to identify imbalances and find corrective measures. However, structural reforms are the hardest for national parliaments to approve because they threaten the interests

of lobbies that are usually well represented in parliament. This was the case with Greece and other countries that requested help. The difficulty of carrying out structural reforms should provide a compelling motive for a country to resort to external constraints on its sovereignty.

The reluctance of countries to undergo adjustment programmes arises from the lack of awareness by the public and the political class that the monetary union is de facto already a political union, imperfect as it is. Europe is often asked to do more, but when the institutions give recommendations for areas still overseen by national authorities, it is considered interference. The most evident example was French President François Hollande's negative reaction at the end of May 2013 to the European Commission's recommendations for implementing a series of structural reforms, including of the overly generous pension system, in exchange for having two more years to reduce the budget deficit below the 3% threshold. According to the French newspaper *Le Monde*, Hollande did not want to be perceived by the French people as being subject to European institutions, although the latter were fully legitimated – and even required – to make such recommendations. This is the contradiction in which Europe and its citizens permanently live.

12. IT'S THE BANKS' FAULT

The banking system is at the centre of the European and global crises. The banks lent too much and were not rigorous enough in deciding who to lend to. They were saved by taxpayers and they did not lend enough to help the system emerge from the crisis. For a system that should have been better regulated, it suffered many faults, perhaps too many.

In Europe the banking sector plays a central role in providing financing for the economic system. The situation is different in the United States where capital is raised mainly through the stock and bond markets. The overall size of the European banking system increased in the years preceding the crisis due to the strong demand for credit from households and businesses, especially in high-growth countries like Spain and Ireland. The banks' role grew also because they began to borrow from other banks by issuing bonds on the market, thereby increasing the system's financial leverage and making it more fragile.

The banks went in this direction for several reasons. In high-growth countries, financing domestic demand required an influx of foreign capital, which the banking system was mainly tasked with intermediating. The banks in countries with deficits turned to the capital and interbank markets, increasing their ability to lend. Even in countries with a high propensity to save, such as Germany, banks had the incentive to take on debt because of the relatively low interest rates, such as those for the liquidity provided by the European Central Bank or directly on the market. These funds were then invested in the interbank market and in the government bonds of other countries, taking advantage of the spread between interest rates and the absence of exchange rate risk.

In the years before the crisis, German banks were among the biggest borrowers both on international markets, thanks to their

good credit standing, and through the liquidity provided by the central bank. German banks in turn lent to the banks in the rapidly expanding countries in southern Europe or in international markets. This increase in financial leverage allowed the lenders to improve profitability and boost their stock prices.

At the outbreak of the crisis various points of fragility in the European banking system came to the fore. First, it had lent to sectors such as real estate that had grown disproportionately and had to be scaled back due to the bursting of the speculative bubble. This led to significant losses for the banks. In addition, the system was heavily interconnected and the ripple effects quickly spread the contagion. Given the large size of the banks' balance sheets, not only with respect to the capital they had lent but also considering the economies of their respective countries, any bank bailout would necessarily be very costly and could cripple public finances.

The segmentation of bank regulation and supervision helped make the system even more fragile. The monetary union was launched without integrating the oversight of the banking system. Each country continued to monitor its banks with potentially perverse incentives. The objective of each bank supervisor, in fact, was not only to guarantee the stability of its system, but also to promote its competitiveness. This encouraged national authorities to protect their systems by limiting the licenses given to foreign banks. This was possible, despite the integrated financial market, thanks to the margin of discretion that European legislation left to the national authorities. The lack of controls or reporting on the countries' use of the discretion granted to them hindered the creation of a truly integrated banking system. Some banks appealed against the decisions of the regulatory authority, but with little success.

In some countries, the national authorities tried to favour the oversized growth of their banking system through 'light' regulation in order to attract new banks and develop the country's financial centre. The respective governments encouraged this trend because of the tax revenue derived from the banking sector. When the first difficulties emerged, the national authorities were reluctant to reveal to other countries the extent of the problem for fear that foreign

banks could come forward to acquire ailing domestic lenders. Solutions were sought at the local level so as to protect the domestic banks.

In summary, the decentralised system proved to be inefficient, undermined competition, hindered financial integration and when problems arose exacerbated the cost for taxpayers.

The collapse of Lehman Brothers in September 2008 showed how risky it is to let a bank fail in the midst of a financial and economic crisis. The cost to the taxpayer ends up increasing considerably. In theory, if a bank is in trouble the ideal solution is to have it acquired by a healthier rival that can absorb the losses. When this is not possible, the only option is to use public funds to recapitalise the bank, restructure it and put it back in condition to operate profitably. This solution, if carried out quickly and transparently, makes it possible to prevent the flight of depositors and potential creditors. It avoids spreading contagion to the rest of the banking system and maintains the stability of the financial system.

This type of intervention, however, is opposed by the shareholders of the banks, because it dilutes their shares. Bank executives are also against it because government intervention is usually accompanied by legislation that restricts their actions and limits their remuneration. The intervention by the state is also opposed by the public, which does not understand why taxpayers' money should be used to prop up banks that made huge profits in the past and were partly responsible for the crisis due to their reckless investment decisions. The rescue of the banking sector is costly not only financially, but also politically.

It takes great strength and political will to overcome these obstacles and act decisively to resolve a banking crisis. There are plenty of precedents, particularly in Northern Europe during the crisis of the early 1990s.

The US government dealt with the crisis by subjecting the biggest banks to a stress test to evaluate the adequacy of their capital base in relation to their balance sheet and to see if there were any negative situations regarding the banks' economic activity or the

value of their shares and loans. When the minimum amount of capital was not satisfied, the bank had to carry out a capital increase within a brief period of time.

The banks that failed the stress test were to receive an injection of public money if they were unable to raise the funds on the market. The result of the stress tests carried out in the United States in early 2009 highlighted a number of critical issues that regulators and the Treasury addressed with an immediate recapitalisation of all the banks. The American operation was successful. The capital increases calmed the markets and the banking system remained solid. Within a year many banks were able to return the capital they had received and the taxpayer lost nothing.

In Europe things turned out differently. The stress tests on the banks were done only in the first half of 2010 by the national authorities with limited coordination at the European level. Some of the basic assumptions, such as the change in housing prices, were too cautious. The impact of a wider variation in the prices of government bonds was not taken into consideration. In the Irish case, the most-troubled bank was not even submitted to the test with the excuse that it had already been nationalised. Initially the publication of the results was not planned.

The results, published in July 2010 under pressure from the markets, were not well received. Fewer than ten banks were found to be below the minimum capital threshold, a non-credible result. The markets became convinced at that point that the national authorities were minimising the problems of their banking systems and had no intention of confronting them seriously. The confidence in the ability of authorities to deal with the euro crisis effectively became so tarnished that the crisis began to extend to other countries and the financial sector.

The publication by international institutions, particularly the IMF, of much bigger estimates for non-performing loans undermined further the credibility of the decentralised system of regulation.

The connection between bank risk and sovereign risk has also long been underestimated. European banks invested heavily in government bonds thanks in part to regulations that drove them to

do so. The progressive deterioration in the credit quality of the public sector was transmitted directly to the banking system. The more a country's public debt is at risk, the more risk there is for the banks that have a high proportion of their assets tied up in that public debt. A sovereign debt restructuring may cause the default of the banking sector, as happened in Greece. Conversely, a distressed banking system that must be stabilised with public funds can put public finances in danger. Saving the insolvent banks threatens to make the public debt unsustainable and the risk is that the banking default causes a sovereign default as seen in Ireland.

Doubts about the solvency of the banking system hindered the proper functioning of the interbank market beginning in 2007, a situation that became more pronounced in the second half of 2010. The banks in countries with savings surpluses progressively stopped extending loans to countries running external deficits. Financial markets were no longer willing to buy bonds issued by banks in those countries. Without external financing, the banks would have rapidly had to reduce their loans to households and companies. The economic system risked collapsing.

In such difficult conditions only the European Central Bank could step in to finance the banks. This type of intervention, however, can only be a temporary solution for restoring confidence and ensuring the system has enough liquidity. It cannot solve the real cause of the problem, which is connected to the insufficient capital base. With national authorities tasked with determining which banks in their own jurisdictions should be recapitalised and under what conditions, there is an incentive to underestimate the problems so as to induce the European Central Bank to continue providing liquidity to all, including insolvent banks.

If the banking system is not recapitalised through public or private funds, financial leverage is reduced on the asset side. This can be done in two ways. The first is to reduce the share of government bonds held by the banks. However, if the banks stop buying their country's public debt, the risk increases that the demand for that debt will be insufficient and the impact on interest rates can destabilise public finances and the banking system as a

whole. The national authorities therefore have an incentive to pressure the banking system to purchase public debt, especially when the interest rate differential is high and the success of the bond auctions is at risk.

These pressures are not entirely unjustified if the country is solvent. In a highly volatile market, any funding difficulties, which can arise in particular with dysfunctional markets, are immediately transferred to the share prices of the banks. It is therefore in the interest of the banking system that the state is adequately financed. Moreover, given the advantageous rates at which banks obtain liquidity from the ECB, investing in government bonds is profitable and over time allows the bank to increase its capital if profits are not all redistributed. However, if the banks purchase government bonds, the link between sovereign risk and bank risk can become destabilising.

To decrease their leverage, the only thing banks can do is reduce their loans to the private sector. Financing dries up with recessionary effects on economic activity. This strategy leads to self-inflicted wounds because the economic downturn caused by the difficulty in obtaining loans increases the likelihood of defaults in the banking sector by weakening its capital base. The inability to recapitalise the banking system adequately risks producing highly recessionary effects on economic activity, which is already burdened by the consequences of a tight fiscal policy.

The political system is unable to escape the perverse web of contrasting forces: people's disdain for the banks, bankers' aversion to public intervention, regulators' fear of revealing critical situations in the banking sector, fear of the effect on government bonds and the pride of governments that motivates them not to seek help from international institutions. The result is inaction, which in turn leads to a credit crunch – a drying up of bank credit – which strangles the economy.

13. BANKING UNION

To break the unhealthy link between sovereign risk and bank risk, which threatens the euro's very existence, the European banking system must be fully integrated with a single set of regulations, a single supervisor and a single mechanism for crisis resolution. To accomplish this, national authorities must cede a part of their sovereignty, but they are willing to do this only when a crisis forces their hand.

In the United States the financial system is the main mechanism for absorbing economic crises that develop locally. When one of the states is hit by economic or financial difficulties the local banking system is only partially affected because it is integrated into a larger system. In 2009-10 many small US banks failed without much consequence for the regional economic systems because an important part of the credit had been granted by national banks, banks based in other states less affected by the crisis or capital markets. The troubled local public finances did not dramatically impact the banking system because the banks had not invested heavily in municipal or local securities and the rescue of troubled banks was not carried out with public funds from the states, but with federal funds. The local economy and local public finance are therefore not linked to the banking system as in Europe.

Since the beginning of the monetary union some have sustained that it is not possible to govern an integrated financial system, such as that of the euro, without a single regulatory authority and integrated supervision. It was argued that keeping national systems, even under the umbrella of European legislation, would hinder market integration for the reasons outlined in the previous chapter. Without a unified system, an economic crisis or problems with a member state's public finances would have caused a chain reaction that could have threatened the very existence of the euro.

After the launch of the euro, various working groups were set up to consider the need to move towards an integration of the regulatory systems and banking supervision. The most noteworthy groups were led by Alexandre Lamfalussy, former President of the European Monetary Institute, and Jacques de Larosière, former Director General of the International Monetary Fund. The two reports, published respectively in 2001 and 2009, both concluded that the present system was not adequate, but they did not have the courage to propose the institutional leap towards a fully integrated system. It took the euro crisis to convince the European Council, in June 2012, to create a banking union.

National authorities have long opposed the unification of banking supervision with the argument that the costs of banking crises are ultimately paid for by taxpayers of the respective countries: "Banks can be born European, but they die nationally." This is why national authorities, who must answer to their country's political institutions, have maintained the responsibility for banking supervision.

From the second half of the 1990s there has been the tendency to separate supervision and monetary policy, giving the former to an institution that reports directly to the government. The reason for this separation is the potential conflict of interest between monetary policy and supervisory activities, which can lead to an underestimation of the banking system's solvency risk and induce an attempt to use monetary policy to solve prudential problems. According to this view, a central bank that is responsible for both supervision and monetary policy might be tempted to steer the latter to solve problems linked to financial stability at the expense of price stability. For example, the central bank could be tempted to delay an increase in interest rates to foster more profitable conditions for the banks and enable them to overcome a difficult period. Errors in supervision can more easily be covered by the central bank through targeted injections of liquidity aimed at compensating the banking system's solvency problems.

The euro crisis showed that these fears were unfounded. Keeping surveillance at the national level and separated from

monetary policy was a mistake. In an integrated monetary system the problems that can arise due to insufficient supervision are paid not only by taxpayers from that country, but from all countries in the currency area. The Irish experience showed that the rescue of a banking system that was supervised poorly and had been allowed to grow too big was paid for not only by Irish taxpayers, but also by those in other eurozone countries: in a direct way through the aid provided to Ireland and indirectly through the contagion to the banking systems of other countries.

It is therefore in the interest of each country's taxpayers that their national banking system is well regulated and supervised, but also that those of the other eurozone countries are as well. Supervisory authorities therefore cannot be accountable only to the taxpayers of their country, but also must answer to the other EU countries. This requires an integrated system.

With regard to the conflict of interest between banking supervision and monetary policy, the experience of the crisis showed that a separation of the two activities creates problems for both. To avoid financing banks that are having solvency problems and not merely a liquidity crisis, the central bank needs to know the health of each bank, in terms of its capital base, asset quality and liability profile. During the crisis, the European Central Bank had to make do with the information provided by the national authorities, which in theory certainly have the ability to assess the conditions of their banks, but which also have the incentive to underestimate solvency problems. The ECB therefore was unable to assess whether the liquidity injected into the banking system was adequate or if instead it risked creating distortions.

The separation between the two activities has had a negative effect not only in the eurozone, but also in countries like the United Kingdom where the Bank of England lost its supervisory role in 1997.

In summary, the problem regarding conflict of interest is relevant only if the central bank is not independent and does not have a clear mandate. However, if the statutory objective of monetary policy is price stability, it is unlikely that a central bank

would have the incentive to make monetary decisions to favour the banking system while jeopardising the realisation of its mandate.

Another argument that has been used to argue that the European Central Bank should not have a supervisory role is that such activities cannot be independent of political authorities given the effect a banking crisis has on public finances. This view in reality hides the desire to exert political influence on the regulator. Supervisory decisions may in fact have an impact on taxpayers that is as important as monetary policy. Moreover, experience shows that in countries where supervisory activities are handled by institutions that are not independent, such as in the UK and Germany, the cost to taxpayers has been higher. The less independent institutions are in fact more easily influenced by banking lobbies and tend to deregulate the system and monitor it in a more friendly way. Also, when difficulties arise in the banking system, political influence leads to a delay in finding solutions for fear of having to ask parliament and public opinion for public funds. The result is that the difficulties worsen and the impact on public finances increases.

At the height of the crisis in June 2012 the heads of government in the eurozone realised that for the euro to survive institutional steps had to be taken to solve the fragility of the single currency's construction. The first of these steps was the banking union.

The agreement on the banking union was an important turning point that put an end to the attempt, which had lasted since the launch of the euro, to maintain supervision of the banking system at the national level. The decision, reached in December 2012, lays the foundation for an integrated system of supervision. The practical implementation will depend on the ability of the European Central Bank to complement the activities carried out so far by the national authorities. The process will take time. The biggest risk for the central bank is to its reputation. In the past, the credibility of central banks, also with regard to monetary policy, was negatively affected mainly by problems encountered in the field of supervision. This was one of the reasons that led some countries in the past to separate the two activities, a step that has however proved to be counter-productive. The problem of reputation can be solved by separating

inside the central bank the decision-making bodies responsible for monetary policy from those that look after supervision. A total separation, however, is neither possible nor desirable. There are in fact synergies between the two areas that must be exploited to the fullest in order to obtain the best possible result.

The real solution to the problem is the independence of the supervisory authority, which is one of the cornerstones of international regulatory principles. A central bank that is independent from both political authorities and banking lobbies is less susceptible to pressures and therefore less tempted to cover up any insolvency issues. From this point of view the European Central Bank, which is further removed from the individual governments and banks than its national counterparts (in the same way that the European antitrust authority is freer from local pressures), should be able to regulate autonomously and scrupulously.

The second component of the banking union concerns deposit insurance. A single system reduces the risk of contagion by allowing for the repayment of depositors up to a maximum amount without weighing on a country's public finances. This entails, however, having the depositors of all countries willing to bear the consequences of a banking crisis that affects another country. This is acceptable if all banks are subject to the same regulations and supervision, otherwise there is a risk of moral hazard.

Given the size of bank deposits in Europe and the limited scope of integrated banking supervision, a single system of European deposit insurance for now remains a mirage.

The third component of a banking union is a regime of crisis resolution that can count on a single fund. In this case an integrated system avoids burdening the public finances of a single country thereby reducing the potentially explosive link between sovereign risk and bank risk. This mechanism however can only come into force after all the banks have been subjected to the same regulator.

A stronger banking union can help accelerate the recovery from the crisis by restoring credibility to the system and easing the credit crunch that threatens to linger in various parts of the continent. Integrated supervision in fact would allow for a more credible

assessment of the financial conditions of European banks, reducing the natural tendency of the national authorities to underestimate the problems. It would also make it possible to give the governments of the member countries clear choices in terms of recapitalising the system, as happened in the United States in 2009, without preferential treatment and with effective measures. It would facilitate the implementation of counter-cyclical measures in a uniform and credible way in all the member countries so as to counteract the tendency to reduce leverage too quickly, which aggravates the economic situation.

These favourable effects on the European economy are contrasted with the political costs to those who currently hold the powers in these matters and would have to give them up.

14. DYING BY AUSTERITY

The budgetary measures put in place to restore the health of public finances had strong recessionary effects and worsened the debt dynamics in the short term. The adjustment should be spread over time to dilute the recessionary effect, but this is possible only if, and until, the state can borrow on the financial markets in a sustainable manner.

The economies of European countries that have implemented restructuring measures to cope with the financial crisis entered a long, worse-than-expected recession. The debt burden increased. This has led some to question the suitability of the economic policy followed in Europe. There is no doubt that austerity puts the brake on growth, at least in the short term, and that without growth it is not possible to set right public finances in a lasting way. On the other hand, if the public finances are not cleaned up in time, debt becomes unsustainable and the country may lose access to financial markets. At that point, austerity is no longer avoidable and it has an even more negative impact on growth.

The objective of economic policy is therefore to ensure the sustainability of the public debt by fine tuning the fiscal consolidation measures so as to favour a budgetary adjustment that is not excessively recessionary. International Monetary Fund studies have shown that the recessionary effect of recent austerity policies was larger than expected. A fiscal adjustment may produce a more-than-proportional decrease in income, increasing debt in the short-term. This does not mean, however, that public finances do not need to be put in order. But the adjustment must be implemented in the most gradual way possible to avoid excessive austerity that produces a debt spiral.

Whether austerity becomes excessive is mainly a question of how and when the adjustment of public finances takes place. Let's

start with the how. To avoid an excessively recessionary impact, one must first understand what factors caused the deficits. There is a difference if the deficit was caused by a reduction in tax revenues or an increase in public spending and this must be taken into account in the adjustment. If the problem is an increase in spending, as was clearly the case in Greece where salaries in the public sector more than doubled in ten years, the correction should be carried out mainly on that side. If the correction is instead made on the revenue side through an increase in taxation, it becomes much more detrimental to economic growth. Likewise, if the deficit has arisen from an overestimation of economic growth, which in turn leads to lower tax revenues than expected, an adjustment carried out through a tax increase can be detrimental because it contributes to reducing growth further. If the deficit is instead caused by an unsustainable tax cut, raising taxes may be unavoidable.

When the public finance measures do not aim to correct the causes of the imbalances, one cannot speak of excessive austerity, but rather of erroneous austerity measures. The problem is not the size of the correction, but the unbalanced mix of expenditures and revenue.

In Italy, for instance, the efforts to cut the deficit have mainly focused on the revenue side of the equation even though the main causes were the constant increase in public spending and insufficient economic growth.

From 1999 onwards, the budgets were almost always based on growth forecasts that turned out to be higher than what actually occurred due to an overestimation of the potential growth of the Italian economy (on average 1 percentage point per year from 1999 to 2006 and 1.6 percentage points from 2007 to 2012). Tax revenues therefore came in lower than expected thus increasing the borrowing requirement. The few times where growth and thus tax revenues were higher than estimates, such as in 2000 and 2007, the extra funds were used to finance increased spending rather than cut taxes or the debt.

Public spending in several sectors grew more than gross domestic product. The salaries of civil servants offer one example. If following the introduction of the euro public salaries had increased

at the same rate as in the private sector and the number of civil servants had remained unchanged, in 2010 the Italian deficit would have been about 3 percentage points less of GDP. This means not only that austerity measures would not have been necessary, in particular in 2011 and 2012, but also that the country would have been better sheltered from the financial market turmoil with positive effects on growth.

One wonders why public finances tend to be brought in line through adjustments on the revenue side (i.e. tax hikes). The first reason is that corrective measures are put in place in emergency situations when the confidence of the markets is at stake. At that point, raising funds through a tax increase is more likely to work. In addition, the increase in revenue is simpler to implement given the relatively limited number of taxes on which to intervene. A reduction in spending instead requires selective measures, the effectiveness of which depends on the ability to modify existing contracts and control local spending. In Italy, in 2012 it took several months to implement a spending review that proved to be complex and produced limited savings. Even linear cuts, with similar cost cuts across all sectors, which seem easier to implement, prove difficult because they unite the opposition of all the beneficiaries of public spending.

It is a paradox that the austerity measures implemented on the revenue side that are the most damaging to economic activity are politically easier to adopt in emergency situations. The discontent in public opinion rises after the emergency has passed and the recessionary impact on growth becomes apparent. It is equally paradoxical that the structural reforms that increase the potential for economic growth and help reduce the recessionary impact of the deficit cutting measures are the most difficult to pass, even in an emergency, due to the opposition of vested interests well-represented in parliament. Even when facing an emergency the reforms are postponed until after the fiscal adjustment, when market pressure will have diminished and the powers seeking to conserve their profitable positions will have grown stronger. Without reforms, austerity becomes excessive because it is applied to a rigid and uncompetitive economic system.

The second yardstick to assess whether austerity is excessive concerns the timing of the deficit reduction measures.

Putting off fiscal rigour, or diluting it over time, is possible only when financial markets are willing to finance the public sector's borrowing needs at sustainable rates. This depends on several factors including the level of public debt, the credibility of the adjustment programme, the country's political stability, the potential that contagion will spread the crisis to other countries and the financial markets' degree of risk aversion. It is not possible to identify with precision the impact that each factor can have on the continually changing assessment that financial markets make regarding the sustainability of a country's public debt. Markets do not react in a linear fashion to an economy's underlying performance, including the imbalances in public finances. Markets can continue to finance deficits for a long time in the expectation that sooner or later corrective measures will be taken. At the same time, markets can quickly change their opinion in the face of unexpected events and can call into question the sustainability of the country's debt.

Until 2008, the financial markets considered the public debt of countries like Italy and Spain to have a degree of risk comparable to that of France or Germany. The Greek crisis, and then the meltdowns in Ireland and Portugal, initially infected the other Mediterranean countries only to a limited extent and interest rates remained at sustainable levels. The markets rapidly changed opinion in spring 2011 and began to consider Italy and Spain increasingly at risk of insolvency. The interest rate differentials, which until then had been contained, widened to extremely high levels. It is not easy to determine with precision what factors influenced market expectations. An important aspect was certainly the deterioration of growth conditions, which made it more difficult to bring down deficits and put at risk the sustainability of public debt. Another factor was the political difficulty in both countries in adopting corrective measures. An important role was also played by the contagion arising from the Greek debt restructuring that began in the spring and was implemented in stages. Some of these factors were in part unpredictable just a few months before and the governments

probably thought they had more time to implement adjustment programmes only to find themselves unprepared when the market situation worsened.

The problem is that governments look at markets through the rear-view mirror while the markets are busy trying to anticipate governments' next moves. Governments have a tendency to think that favourable debt financing conditions will last forever and that there is always more time to take corrective measures on the budget. The adjustment effort therefore gets diluted over a long period of time as part of a gradual approach to consolidation of public finances. When the general market conditions change due to an economic slowdown, a domestic political crisis or contagion caused by external factors, the timing of the adjustment must be rapidly shortened. Recovering confidence at that point requires much more drastic and punitive measures for the economy. When governments are too slow in implementing the changes needed to ensure the sustainability of the country's public finances and act only under the pressure of financial markets, austerity becomes excessive. The problem is that at that point there are no alternatives.

If the Greek government of Papandreou had taken convincing steps beginning in the fall of 2009 to regain control of public finances, the country's adjustment and that of the entire eurozone probably would have been less dramatic. The same applies to the other countries that subsequently entered into crisis, from Ireland to Italy, and adopted corrective measures only after losing the confidence of the markets. At that point draconian measures were needed to regain confidence and continue to finance the debt at sustainable interest rates.

The excessive austerity is not a product of the fiscal consolidation itself, but rather of having waited too long to implement it. No government is willing to recognise this. It is easier to blame the financial markets that have stopped funding the country's public debt at a low cost.

The other favourite scapegoats for those unable to consolidate public finances preventively are the European institutions and the governments of creditor countries that are guilty of imposing too

much austerity. Experience shows that, if anything, the European institutions should have monitored more rigorously in periods of buoyant financial markets so as to prevent governments from delaying for too long the corrective measures needed to improve their public finances. They also should have taken into greater account the fact that the apparent good condition of public finances in some countries before the crisis, such as Ireland and Spain, was in part due to the unsustainable growth of domestic demand that boosted tax revenues. Moreover, without the help of the European institutions the countries that lost access to the financial markets would have had to implement even more restrictive adjustment policies. Greece, Ireland and Portugal would probably have defaulted, with even worse recessionary effects. European aid allowed countries to spread their corrective measures over time. The problem, as pointed out in Chapter 11, is rather that struggling countries accepted external aid only at the last minute. Excessive austerity is the price to pay for national pride.

The search for scapegoats and dumping on others the job of implementing consolidation measures, which is the responsibility of the individual countries, undermined confidence within the EU and towards the EU. It did not help countries focus on the causes of the crisis or find a consensus to resolve them. Countries consequently realised too late what problems they faced and responded with excessive measures, which at that point had become inevitable.

The risk of dying by austerity is attributable only to the inability of political institutions to make the right decisions at the right time.

15. NATIONAL AUSTERITY AND EUROPEAN GROWTH

If structural reforms are postponed until after fiscal consolidation, the political costs of those reforms increases and they tend to be watered down. Growth stagnates and at that point the only option is to appeal to Europe to promote growth policies. And though Europe does not have effective tools for stimulating growth – which the member states have not wanted to grant to the EU – it gets accused of not doing its part.

The euro crisis is largely a balance of payments crisis, which was thought could not occur within a monetary union with full capital mobility and no exchange rate risk. But when a country grows systematically beyond its potential and loses competitiveness, it borrows too much from the rest of the world – as has happened in Greece, Ireland and Portugal that in less than ten years accumulated external debt of about 100% of GDP – and the risk of investing there rises to worrying levels and can lead a sudden stop of financial flows. At that point, the adjustment becomes very painful.

In a monetary area an external deficit can be corrected through a combination of measures that aim to suppress domestic demand so as to reduce imports and stimulate supply by improving the competitiveness of exports. The combination of the two types of measures depends on each country's economic policy choices. The adjustment on the demand side has a direct impact on the external deficit, but the negative effect on growth and employment is just as strong. The adjustment on the supply side has a more favourable impact on economic activity because it promotes sectors driven by demand coming from the global economy. However, it is more complex because it requires structural reforms and cost control measures that are politically difficult to implement.

The competitiveness of a country depends on its ability to attract productive investments and the relative prices of its exports. There are several indicators that measure the competitive positioning of a country, both structural and in terms of costs. Nearly all the structural indicators place Italy, Spain and other Southern European countries at the bottom of the rankings due to the hurdles companies face as a result of a complex bureaucracy, a slow judicial system, corruption, outdated infrastructure and a high tax burden. These countries lost competitiveness also in terms of costs as salaries rose faster than productivity and as a result of a high tax wedge, which represents the difference between the gross salary paid by companies and the net received by the worker. The obsolete infrastructure also inflates the costs of international transportation. If the time necessary for logistics and bureaucratic proceedings at the Italian port were the same as in the Netherlands, Genoa could become one of the main hubs for global trade, benefitting Italian firms and the local economy.

The competitiveness of individual companies largely depends on the ability of their home country to provide services at costs similar to or lower than those of other countries. Improving productivity thus requires action at a national level, in order to align costs and procedures to those of other countries. Such measures, however, are not easy to adopt in a country that has an ingrained aversion to change and is bound by a commitment to reduce its budget deficit and public debt. To boost their competitiveness these countries must intervene in all the areas where they lag behind the best performers: public administration, judicial system, overdue payments from the state to companies, corruption, labour market, research and development, liberalising closed professions and infrastructure. The continued failure to act along these lines explains why a country like Italy for years has recorded the lowest growth rate among European countries.

These reforms are politically costly because they promote competition and threaten sheltered positions. The opposition of vested interests blocks a democracy's ability to reform. In order to overcome resistance, economists suggest compensating those affected by the reforms. This is difficult, however, when public

resources are scant. Reforms are generally tackled only after fiscal measures have been adopted to face the emergency situation at which point there are no resources left to give to those who have been hurt by the reforms.

Moreover, competitiveness depends also on the tax burden, which distorts the allocation of resources. The experience of the higher-growth European countries shows that public funds should be directed with priority to education and research and development, which have an effect on medium-term growth potential. Fiscal policy is a tool used both to make it attractive to invest and to reduce the tax wedge with the goal of cutting labour costs. These measures do not weigh on the budget if they are offset by counterbalancing measures that penalise current public spending – in particular the salaries of public employees and intermediate consumption – and steer taxation towards consumption and income.

In Italy, public finances have for years gone in the opposite direction of what was needed to improve the country's competitiveness. Current spending rose at the expense of research and development, which is among the lowest in Europe, and taxation tried to incentivise consumption and real estate. The result has been the slowest growth rate in Europe over the last 20 years.

Competitiveness depends ultimately on the dynamics of prices and costs. Italy and Spain also lost competitiveness in this field prior to the crisis and subsequently have been unable to reduce the gap. Inflation remained above the eurozone average after 2008 despite the countries' lower growth. In 2012, Italy's real effective exchange rate, which measures the inverse of competitiveness with the main trading partners, was about 40% higher compared with the launch of the euro, the same level reached in 2008 before the crisis. Spain instead recovered about 20 points of competitiveness between 2008 and 2012 while Ireland gained 40 points.

Italy's loss of competitiveness is largely the result of stagnating productivity in the face of constant wage increases in both the manufacturing and services sectors. The mismatching between productivity and salaries is due to the fact that in Italy, unlike in the rest of Europe, wage negotiations are not linked to companies'

performance. This discourages companies from investing in their human capital and hampers productivity gains.

The difficulty in implementing robust reforms to improve competitiveness means that the external adjustment falls largely on the demand side and is more costly in terms of growth and employment. In Italy, for instance, reforms always come second, the opposite of what should happen. In this regard it is interesting to note that the letter the European Central Bank sent to the Italian Government on 5 August 2011, contained as the first recommendation a number of structural reforms to boost productivity, in particular the liberalisation of local public services and of closed professions, privatisations and changes in the labour market, welfare system and wage negotiation system. Fiscal adjustment came only second with the request of bringing forward the balanced budget target to 2013, mainly through spending cuts and by completing the pension reform. A third point was related to the public administration, in particular the abolition of the provinces. Later recommendations by the European Commission set the same priorities. Italy did the exact opposite. It first proceeded with the fiscal adjustment, chiefly through revenue raising measures, during the summer and at the end of 2011. Reforms were tackled only during the course of 2012 and carried out only partially.

The combination of a tighter fiscal policy and incomplete structural reforms produced a strongly recessionary impact on the economy with negative repercussions in terms of social cohesion and the public's acceptance of the measures taken. In the absence of economic growth malaise tends to spread among the population. The government's choices are thus called into question and the blame usually falls on fiscal austerity measures rather than the lack of reforms.

This course of action deeply hurts the economic system and does not help the government survive. Eventually governments fall for failing to revive the economy after carrying out a fiscal adjustment. This is what happened in Italy both in 1998, to the government headed by Romano Prodi, and in 2012, with the executive headed by Mario Monti.

Frustration at the economic stagnation hammers the government's approval ratings and motivates the request that EU institutions act to stimulate demand. These requests generally refer to two types of proposals. The first aims to "loosen the austerity straight jacket" to postpone the fiscal adjustment for example by excluding public investments from the deficit calculation. The second regards EU initiatives, financed with European funds, to build cross-border infrastructure. Albeit legitimate, these demands create unrealistic expectations of the European Union's ability to promote growth in troubled countries and risk drawing attention away from the true causes, which are internal, that hamper growth.

The idea of excluding public investment from budget deficit calculations has repeatedly been discussed, and each time has been rejected. Measuring public investments and distinguishing them from current expenditures is problematic but what is also difficult is to assess their actual contribution to economic growth. Countries that have poor access to financial markets can justify boosting their debt to finance investments only if the multiplier effect on the national output is such that over time it leads to a reduction of the debt-to-GDP ratio. Otherwise, there is a risk that public debt rises further, sinking the country into a downward spiral.

In most cases, the problem of insufficient public investment arises from policies that promoted current spending, in particular during a fiscal adjustment. It is politically easier to reduce the deficit by postponing public works rather than by cutting the salaries of civil servants, even when those salaries have risen excessively. Over time, distributing public resources in this way hurts the economy and leads to a reduction in growth potential.

Cross-border investment programmes, which are financed with EU funds, yield results over the medium-term. They can, however, hardly be used as counter cyclical instruments. Besides, such investments are usually split among countries based on their share of financing, which means it is difficult to funnel sizeable funds to just a few specific countries.

All in all, the EU's tools for boosting development are limited. Europe is often accused of not making decisions, but the motive is

the lack of tools. No country wants to hand over powers that affect key areas for competitiveness and potential growth, such as the labour market or the judicial and education systems. The idea that economic growth can only be promoted at a European level is seductive, but it clashes with the continent's institutional and political reality. Proof of this lies in the fact that some eurozone countries have been able to grow at a considerable pace while sticking to budget discipline thanks to internally adopted structural reforms.

To ask the EU to stimulate economic growth risks creating a big illusion as well as frustration at the integration process. Fiscal discipline must come from the national level just like the ability to promote growth, which depends in large part on how the fiscal discipline has been implemented. If done well and selectively, fiscal discipline creates the conditions for growth and stability. Fiscal discipline that is late and poorly thought out becomes austerity and hurts growth.

16. A GERMAN EUROPE

If every country became like Germany, then Germany could no longer be Germany. If countries with external deficits were the only ones to correct their payment imbalances, then demand for exports from countries running surpluses like Germany would fall. The economy of the whole eurozone would suffer without an alternative source of growth to compensate for the drop in demand from countries undergoing a fiscal adjustment.

Before the financial crisis the eurozone had roughly balanced trade with the rest of the world. This led Europeans for a long time to believe they were immune to the crisis. But monetary integration in the area was not advanced enough to make the internal imbalances immune to funding problems. The divergence among national economies continued to rise and eventually became unsustainable with gaping deficits in peripheral countries such as Greece, Spain, Portugal and Ireland and rising surpluses in countries such as Germany and the Netherlands. If the crisis that originated in the United States had not hit Europe then the imbalances would have grown even further.

The correction of imbalances within the eurozone can happen symmetrically or asymmetrically. An asymmetrical correction takes place chiefly in countries running a balance of payments deficit (such as Spain). But its recessionary impact extends also to surplus countries (such as Germany) as demand for their goods shrinks. In other words not all countries can have a surplus in their balance of payments at the same time so for deficits to be cut then surpluses must also fall, resulting in a negative impact on the whole area's economic growth.

A symmetrical adjustment entails a combination of measures to curb demand in countries running deficits (such as Spain) and stimulate it in surplus countries (such as Germany), which allows imbalances in both countries to fall while maintaining a sustained

level of economic growth in the area. Stronger demand in a surplus country (Germany) helps exports from a deficit country (Spain) and softens the impact on growth linked to a lower demand for German goods from Spain.

On paper, the symmetric adjustment is preferable, but it is not so simple. International institutions debate the issue whenever they discuss an adjustment of the US balance of payments. If the adjustment took place only through a contraction in US demand, without an increase in demand from surplus countries such as China, Japan or Germany, then it would lead to a slowdown in global demand. But surplus countries do not want to adopt expansionary policies that could undermine their public finances for their currency. The only time a concerted symmetric plan was attempted was in 1978 at the Bonn G7 summit, which led to European countries embracing fiscal stimuli in an attempt to help a correction in US imbalances. The outcome, however, was disappointing. The immediate impact was an overheating of the world economy that subsequently forced countries to adopt tightening measures precipitating a recession in the early 1980s.

The same issue was for years on the table of EU negotiations, particularly when discussing the adjustment to be implemented within the European Monetary System. The burden of correcting imbalances has always fallen on countries whose currencies were under downward pressure, had lost competitiveness and ran an external deficit. The surplus countries with stronger currencies, in particular the German mark, acted as an anchor for the system through their stability policies. The adoption of the single currency allowed countries to overcome the asymmetry of the monetary policy but not of other policies that impact the balance of payments.

The debate on the symmetry of adjustment is generally misguided. It focuses mainly on the correction of external imbalances but overlooks both the factors that led to the imbalances and the internal consequences of the adjustment in terms of growth and inflation. The reason is that while the factors that led to an external deficit are usually easy to pinpoint, such as excessively high costs and prices as well as booming demand in the face of insufficient

supply, the elements behind a current account surplus are not always that clear. It can be due to lower-than-potential growth, an increase in savings as people look towards retirement or a country's improved competitiveness.

A symmetric adjustment is appropriate if the country in surplus is growing below its potential and has room for an expansionary fiscal policy without compromising the sustainability of public finances. If, instead, the country in surplus is close to full employment and is growing robustly, or its public finances are fragile, an expansionary policy risks creating inflation and worsening the debt.

In Germany, for example, the current account surplus increased beginning in 2001, when the German economy went into recession and the budget deficit rose above the 3% threshold. If fiscal measures aimed at stimulating demand had been taken, the deficit would have increased still further going against EU recommendations. The external surplus continued to increase in subsequent years as the economy rapidly recovered, despite the slowdown in countries running deficits and even though unemployment continued to fall. The public debt stabilised in 2012 at just under 90% of GDP. In these circumstances it is not clear whether there is room for a fiscal stimulus without jeopardising debt sustainability and fuelling inflation.

Until the outbreak of the crisis wages in Germany had risen moderately and less than productivity, which allowed the country to recover competitiveness after unification and reduce unemployment even during the crisis. In this context, the labour unions are not in favour of salary increases that risk reducing the German economy's competitiveness. Moreover, the labour market promotes a high degree of flexibility in terms of wages and hours worked that makes it possible to sustain employment even in times of shrinking demand (as was the case in 2009) and prevent wage increases that result in higher costs.

In summary, the analysis of the scenarios prior to the crisis shows that imbalances within the eurozone were created primarily by deficit countries as a result of the excessive growth of

consumption and wages that were not in line with productivity. The correction of imbalances therefore had to fall mainly on them. This is why the demands for symmetric adjustment, advanced on several occasions in particular by Christine Lagarde, who at the time was France's Minister of Finance (before she became Managing Director of the IMF) and claimed that "you need two to tango" have always been rejected by Germany. Wolfgang Schäuble, the German Finance Minister, has always noted that competitiveness is earned with wage moderation and by investing in research and development. He has also always said that Germany's finances are too fragile to risk being jeopardised by expansive fiscal policies that would have a limited impact on the demand for exports from uncompetitive countries.

Moreover, with world trade evermore integrated, global competitiveness cannot be measured only within the eurozone, but must above all be determined in comparison with of the rest of the world, including emerging countries that have lower costs. The adjustment within the eurozone cannot put at risk the ability to compete globally.

From the German point of view, the external surplus is not the result of policy choices, but rather Germans' high propensity to save due to worries about the problems associated with an aging population. According to this view, a mature economy like the EU should have an external surplus and should export capital to less developed countries where growth is faster. The Germans' strong propensity to save, however, also reflects a system of taxation that tends to penalise consumption.

The adjustment of imbalances within the eurozone depends in part also on the more general context. So far demand for German products from emerging countries has partly offset the decline from EU members carrying out fiscal adjustments and therefore Germany has been affected only minimally by the fiscal problems inside the eurozone. In addition, the decline in interest rates in Germany that followed the accommodative policies of the ECB and the influx of capital from other countries has created favourable conditions for the growth of consumption and investment. Wages began to grow faster in Germany than in other countries. However, Germany's favourable

situation could change if the world economy began to slow, especially in emerging countries, and demand for German exports fell.

All in all, it is inevitable that the recovery of competitiveness by countries with deficits will lead to an evolution of their growth model with less dependence on the domestic market and a greater exposure to international markets. This development is in part desirable for the countries of Southern Europe that are relatively closed to international trade. For the area as a whole, however, which is the largest economy in the world after the United States, over-dependence on external demand, risks tying growth too much to exogenous developments beyond European control.

The problem becomes alarming when you consider that many emerging countries, particularly those in Asia such as China, also base their model of development on exports. With continued integration of world trade, where there is still much room for growth and the expansion of comparative advantages, exports can be an important source of development for economies that are being integrated. But when the situation normalises, over-reliance on exports by all countries is unsustainable.

A 'German' eurozone, with an economy that is more reliant on exports and not counterbalanced by a more 'European' Germany – that is to say with a more developed internal market – risks growing more slowly and being more susceptible to the oscillations of the world economy. To ensure this does not happen, it is not necessary to have more coordination of national fiscal policies, as is often called for. The margins for a strengthening of the common procedures were expanded with the package of measures adopted in late 2011 – in particular the establishment of the 'European semester' – in preparation for national budgetary policies.

What is needed is more integration of national markets to create a true single market that will make it possible to develop autonomous growth on the continent. There are ample margins for greater economic integration as highlighted in the Monti report presented to the European Commission in May 2010. The unfortunate coincidence of timing that tied it to the outbreak of the

euro crisis encouraged European institutions to give priority to emergency measures. In many respects, particularly with regard to finance, the crisis led to a renationalisation of the markets. It is time to get back to basics and adopt new integration measures to favour the adjustment of imbalances and create the basis for more balanced growth.

17. THE EUROBOND ILLUSION

The euro is unsustainable without a fiscal union. Issuing a single debt instrument, the 'Eurobond', does not mean that the fiscal union has been achieved. Countries must give up control of their budgets otherwise the issuance of joint public debt will spin out of control and threaten the monetary union's viability. However, it is not clear how many countries are ready to take this political step.

The best way to build a fiscal union is to create a single debt instrument. With debt guaranteed by all states, there would be no differences in interest rates among countries. There would be less risk that a country would be pushed to the brink of insolvency due to the unsustainable interest rates it has to pay on its debt. A common debt instrument, issued jointly by the eurozone countries, would also accelerate the integration of Europe's financial markets. It would make it possible to separate banking risk from sovereign risk, thus avoiding a dangerous catalyst of crises. The proposal was put forward in various contexts and also examined by the heads of state.

The creation of Eurobonds would mirror the path the United States followed to create a fiscal union after the American Revolution. Treasury Secretary Alexander Hamilton convinced Congress that the only way to avoid a financial crisis was to pool the debts the states had accumulated. If Europe is not ready to take this step the euro is in danger, according to many economists, especially American.

Following the 'American road' sounds attractive, but it is not as simple as it seems. When transferring the debt to the federal government, Hamilton also centralised tax revenue and the power of taxation. The debt, in fact, must be secured by tax revenues. The debt issuer must be able to generate enough resources to pay at least the interest.

The transfer of power to issue debt from the individual countries to the European Union, through the creation of Eurobonds, requires the transfer of fiscal resources from the member states to the EU. This can be achieved only through a change in the treaty that shifts decision-making powers on fiscal policy from the member states to the EU. The issues to be addressed are numerous and complex. It must be decided which institution has the job of defining the total amount of securities to be issued and then how much will be transferred to the individual countries. It also must be clarified what happens if a country breaks the deficit ceiling and how pre-existing debt will be treated. These issues seem to be ignored in many of the proposals made for the introduction of Eurobonds. This raises the suspicion, especially in countries with more solid public finances, that the proposal is just a way to spread the risk without sharing the responsibility of fiscal policy, which would remain with the individual countries.

The key issue is the rigidity of the budget constraints. If the limits for the issuance of Eurobonds are not binding and remain similar to those outlined in the Stability Pact, there is the risk that some countries would sell more debt than foreseen and the others would be forced to guarantee it. The sanction mechanism would not be enough to deter self-interested behaviour and countries would have the incentive to issue too much debt. Budgetary discipline would be lost to the detriment of the more virtuous countries. A similar system was in force in Yugoslavia and it proved to be unsustainable.

The power to issue Eurobonds would have to be delegated to a European authority, an agency for common debt, which would distribute the funds raised on the market to the member countries according to a predefined plan. This solution would have two advantages. The first would be to avoid excessive deficits and therefore undisciplined fiscal policies. Such a system would have prevented Greece from hiding for years the true size of its deficit. The second advantage would be to trigger automatically the conditionality for countries that need to increase their debt beyond what was initially allowed in order to deal with an external shock or

an unexpected slowdown in the economy. The funds would be raised by the European agency and disbursed to the country under specific conditions regarding fiscal consolidation and adjustment policies. The European agency de facto would replace the bailout fund.

The proposal, however, raises two types of problems. The first concerns the decision on the total amount of debt issued by the European agency and how it would be divided among the countries. Given that it would be a group decision taken at the European level, it is de facto an integration of national budgets into a single entity with joint decision-making power. The member states could maintain sovereignty over the composition of revenues and expenditures, but not on the overall amount, which would be decided centrally.

This would be a major step forward towards political integration in the eurozone. Deciding together the state budget entails centralising an essential component of sovereignty that is typically exercised by national governments and parliaments. On the other hand, the Stability Pact already requires countries to submit their budgets for approval to the European Council of Ministers, which may draw up specific recommendations and request changes to the proposed budget. Nevertheless, under the current system ultimate responsibility lies with the member states. There are penalties for infringements, but they are limited in scope and are only applied later.

The Eurobond puts the responsibility for the total public debt and the debt of each country on all eurozone countries. The transfer of budgetary powers to the European level must meet the criteria of democratic legitimacy. This requires a modification of the treaty, in particular to strengthen the powers of the European parliament.

In Italy, one of the countries where there seems to be the most enthusiasm for Eurobonds, it is not clear whether there is as much willingness to cede to European institutions decision-making powers on the Italian budget. Fiscal policy is still considered the responsibility of the individual countries and many politicians do not miss the opportunity to complain about the lack of room for

manoeuvre. If the EU was responsible for deciding the overall thrust of the Italian budget, it would most likely follow the indications of the Fiscal Compact, adopted in 2012, that calls for a reduction in the public debt of four percentage points of GDP per year. Presented in these terms, greater budgetary discipline in return for Eurobonds, one wonders how many Italians would still be so enthusiastic about the proposal.

In France, the new president François Hollande initially was in favour of Eurobonds to try to get some negotiating advantage with Angela Merkel, but he quickly backtracked well aware of his country's aversion to ceding fiscal sovereignty.

Proposals have been made to create Eurobonds without transferring sovereignty. For example, it has been suggested that Eurobonds could be issued against collateral such as equity stakes, real estate and even gold conferred by the respective countries to a common European fund according to pre-established quotas. If a country is unable to repay its debt, the fund takes possession of the collateral. This mechanism can, however, be created at the national level so it is not clear what the advantage of doing it together would be. Moreover, the transfer of some of the state's assets to a fund as collateral for the issuance of new bonds increases their quality compared with bonds already in circulation, which will consequently lose value as they become relatively more risky. This would lead to a segmentation of the market and result in significant losses for holders of existing bonds with negative consequences especially for financial institutions that must put in their balance sheets the market value of their securities.

It is worth considering what would have happened had Eurobonds been launched in the eurozone at the time of the euro's introduction. As mentioned, the out-of-line budgets, particularly in Greece, probably would have been avoided in the period preceding the crisis. However, the external imbalances within the eurozone probably would still have developed because these were favoured by the convergence of the interest rates of the various countries' government bonds (something that would have occurred even if the Eurobonds had existed from the beginning). In Spain and Ireland, for

example, the ability to borrow at low interest rates fuelled the financial leveraging of the banking system and favoured the use of easy mortgages by households to buy real estate at inflated prices. Eurobonds would not have prevented the accumulation of such imbalances, which perhaps would have been even larger. The same applies to other factors that created imbalances that depressed growth in Italy and Portugal during the decade preceding the crisis.

At the outbreak of the crisis, the rising public deficits of these countries would have been financed through Eurobonds, and therefore at favourable rates and without the risk of contagion or a debt spiral during the recession. However, the amount of debt these countries could have issued would not have been decided by their respective governments, but rather by the European Union and it would thus have been subjected to structural reforms and corrective measures to the public finances. The situation would have been very similar to what occurred in countries that resorted to the bailout fund. Instead of asking the fund for aid to cope with the crisis, the country would have had to ask the European agency in charge of debt to issue additional Eurobonds. The bonds would have been issued only as part of an agreement that included a restructuring programme. The request would have been politically less penalising than asking the bailout fund for aid, because a larger number of countries would have been involved and it would have been carried out before the country needing the additional Eurobonds had lost access to financial markets. The system would certainly have been more efficient and less destabilising for the entire eurozone.

The crisis would have been addressed earlier in Greece and would have had less devastating effects on the country and there would have been less contagion. The Karamanlis government would not have been able to finance its campaign with hidden public debt. The deterioration of a country's fiscal situation would have been tolerated by European institutions only in exchange for corrective measures to public spending and reforms aimed at improving tax collection. The problem of the backwardness of Greece's tax system would have been addressed much earlier.

Eurobonds would not solve the problem associated with the different levels of debt accumulated so far in the various countries. Transforming all existing debt into Eurobonds would mean transferring the debt of the less disciplined countries to the more virtuous ones, something that is unlikely to be accepted by the latter. One possible solution proposed by some German economists is to convert all the debt in excess of 60% of GDP into Eurobonds. This would be coupled with a strict debt reduction plan to be carried out in a given period of time forecast to be 20 years. In this scenario, the budget constraints imposed on the high-debt countries would be very rigid.

This solution does not solve the problem of providing the EU with a safety net to deal with exogenous shocks that destabilise public finances.

In summary, the introduction of Eurobonds would be an important step forward toward economic and political integration in Europe and would strengthen the solidity of the euro. However, it is important not to create the illusion that this proposal can be implemented without major modifications to the decision-making processes, such as fiscal policy, that are at the foundation of European democracies. Eurobonds entail a loss of national sovereignty, or rather a sharing of sovereignty between all countries regarding public budgets.

18. PRINTING MONEY

To exit the crisis more rapidly the European Central Bank could print euros, buy the government bonds the market no longer wants and reduce interest rates to stimulate consumption and investment. The recipe seems simple, but it hides a number of pitfalls.

Whenever central banks have intervened in the past to finance governments, the creation of money has led to inflation that burned people's savings. This is why the European Central Bank was made independent and given the primary objective of ensuring price stability and the explicit prohibition of directly financing member states.

Central banks choose their instruments of intervention according to the structure of their financial markets. In the United States, the monetary base is created primarily through the purchase of government bonds on the secondary market (not at the time of issue). The reduction of interest rates on government bonds is transmitted to the rates paid by private borrowers, especially households and businesses, and stimulates consumption and investment. In the eurozone the financial system is mainly based on bank credit. This is why the European Central Bank implements its monetary policy mainly through financing operations of the banking system rather than open market operations as the Federal Reserve does. In the European context the purchase of government bonds by the central bank is more complicated because there is no joint eurozone bond. To mimic what happens in the US, the ECB would have to buy a predefined basket of government bonds issued by all eurozone countries, which would be inefficient and would create distortions in the financial markets. The methods used by the ECB are therefore more suited to the European context and allow the central bank to protect its balance sheet more effectively, and

therefore taxpayers since the loans are secured by the collateral deposited by the banks and are carried at floating interest rates.

Comparing the operations carried out by the ECB and those of other central banks during the crisis shows that the overall impact on liquidity is comparable even if the instrument of monetary creation is different. The size of the ECB's balance sheet increased mainly through financing to the banking system, while the Federal Reserve's assets are mainly public and private securities.

The real problem for European monetary policy is that monetary impulses are not transmitted uniformly to the different eurozone economies due to the segmentation of the money and financial markets that occurred as a result of the sovereign debt crisis. Already in the summer of 2007, with the beginning of international tensions, the interbank liquidity market showed its first signs of being under stress. Banks were no longer comfortable lending funds to one another. The ECB had to replace the market, intervening to provide liquidity directly to the banks. The problem worsened in 2010 when the debt crisis in some countries spread to their banking systems. Without access to the credit provided by the European Central Bank, banks in those countries would have collapsed and exasperated the crisis. The central bank offered unlimited fixed-rate financing with collateral. This was not enough, however. Interest rates on loans to households and businesses remained high because of the risk on government bonds. Acting only through the banking system was no longer sufficient to loosen credit conditions and counteract the recession. Monetary policy's transmission mechanism had stopped working. The countries that were carrying out fiscal consolidations suffered from an overly restrictive monetary policy and the adjustment became almost impossible.

To avoid sending the economy into a downward spiral, interest rates on loans to the private sector had to come down, but this could not happen as long as the yields on government bonds remained as high as they were. The interest rates on public debt are the benchmark for the entire financial system because they reflect investor confidence in the country.

To reduce interest rates on government bonds, fiscal authorities must enact a credible consolidation. The adjustment is successful when the planned consolidation is timely and the markets quickly incorporate the change of direction in their expectations. The longer a country waits to take steps to improve its finances, the higher the risk premium goes and the more drastic the adjustment steps will have to be. In a currency area there is a further complication. Given the separation between monetary policy and fiscal policy, a country cannot turn to the central bank to finance its debt. If the budgetary adjustment is not effective, there is an increasing risk of debt restructuring, or even default. This risk is partly endogenous. The higher the yield on government bonds, the more drastic the budget measures to bring the accounts back in order will have to be and the higher the risk that the economy will enter a vicious circle and spiral out of control. If interest rates rise beyond a given threshold, public finance can become unsustainable regardless of the measures taken. If the market becomes convinced a country has a high risk of default and interest rates rise, the possibility of avoiding default diminishes. The expectations feed on themselves and eventually become self-fulfilling even if they were not justified to begin with.

Markets are not always rational. Expectations are determined on the basis of political and economic events that can shift the system from an apparent sustainable equilibrium toward instability even when the country is solvent. In these conditions, monetary policy is ineffective. Market instability caused by uncertainty about the health of public finances hinders the task of monetary policy.

The European Central Bank at this point could step in and buy a country's government bonds thereby bringing yields down to sustainable levels. In this way it would contribute to restoring stability and improving the ability of markets to assess risk. This move is justified if the high yields are being caused by financial market instability that is making it impossible for investors to assess properly the underlying conditions of the economy and in particular the sustainability of public debt. If, instead, high government bond yields are due to an insufficient budget adjustment by the country and reflect the risk of insolvency, the central bank's intervention

risks becoming monetary financing of the state. Therefore, when the central bank intervenes it must be certain the country's public finances are sustainable.

The European Central Bank finds itself facing a dilemma. If it assesses that a country's public finances are sustainable when they are not, it risks carrying out monetary financing of a member state that can generate losses for the entire system. If, however, the central bank estimates that the public finances are not sustainable when in fact they are and decides not to intervene, it risks destabilising markets with knock-on effects on other countries and recessionary repercussions on the economy of the entire area.

This is not a theoretical problem as it concerns the independence and democratic legitimacy of the European Central Bank and therefore of the EU itself. The European Central Bank is independent and can operate autonomously because it has a clear objective – price stability – that benefits all citizens. If the bank's actions result in a deliberate redistribution of resources within the eurozone then it is not fulfilling its mandate and it would be encroaching on the responsibilities of political authorities without having the legitimacy to do so. It would be criticised, especially by countries penalised by its decisions. The very foundations of the EU would be undermined. On the other hand, the central bank cannot avoid intervening in the markets if this is necessary to achieve its objective, and consequently it cannot avoid taking risks, especially in a highly unstable situation. Therefore it is essential that any intervention by the bank is motivated by its statutory objective, price stability.

Moreover, it should be noted that the ECB is led by a Governing Council composed of the six members of the Executive Committee, who reside permanently in Frankfurt, and the governors of the central banks of the 17 countries that are currently members of the euro. Each person has one vote so the governors of the central banks of Luxembourg and Malta have the same weight as their German and Italian counterparts, as well as that of one of the 6 members of the Executive Committee. This system can work and be considered legitimate by the citizens of the various countries, in

particular the most populous ones, if each member participates in the decision-making process in a personal capacity and does not represent the interests of their country of origin. If the European Central Bank's actions were to result in a redistribution of income in favour of one country or another, there could emerge the suspicion that the members of the Governing Council are seeking to promote the interests of their respective countries. That would delegitimise both the decision-making process that is the basis of the independence of the ECB and the very concept of a supranational and federal institution that aims to benefit its citizens.

This system has been severely tested in recent years. On several occasions governments considered that the members of the Governing Council represent their respective countries and therefore are available to act on their behalf. Yet the treaty clearly specifies that "the governments of the EU member states must also respect the principle of (central bank) independence and not seek to influence the members of the decision-making bodies of the ECB or the national central banks in the performance of their tasks".

The problem was exacerbated during the crisis when it emerged publicly that the opinions expressed by some members of the Governing Council on the occasion of contested decisions, such as the purchase of government bonds of distressed countries, reflected the prevailing public opinion in their respective countries. The fact that two successive presidents of the Bundesbank, who sit on the ECB's Governing Council, have spoken publicly against the purchase of government bonds – on the occasion of the first purchase programme agreed in May 2010 as well as the second programme in August 2011 and the new programme of open market transactions in September 2012 – led observers to assume that also the other members of the Governing Council were expressing opinions in line with the positions of their respective countries, thus undermining the ECB's independence. Chancellor Merkel's public defence of the ECB's decision in September 2012, which Bundesbank President Jens Weidman had openly criticised, helped restore the idea that each member of the Governing Council acts on their own behalf and not that of their country.

In summary, in order to operate effectively the ECB must justify its actions based on the strategy for monetary policy adopted to fulfil its mandate. This is why the central bank is not – and must not be perceived to be – the lender of first or last resort. If that were to happen it would be the end of the euro.

19. BUYING TIME

Monetary policy is a powerful tool because it affects the conditions under which an economy, including the public sector, is funded. However, by itself it cannot resolve the problems connected with excess public or private debt. Monetary policy can only provide time so adjustment measures can be implemented, but if it allows too much time the incentive to remedy the situation decreases. Monetary policy thus risks being counterproductive.

After an agreement to help Greece had been reached in May 2010, the financial markets realised the eurozone was not prepared to deal with a systemic crisis. The complexity of the negotiations with Greece showed that it would be difficult to pull off another rescue if other countries were forced to ask for help. Moreover, the economies in Ireland and Portugal were quickly deteriorating.

Without an efficient safety net the euro was in danger. It was necessary to create a European institution able to operate like the International Monetary Fund to help distressed countries. The IMF's programmes – based on macroeconomic and structural adjustment measures, a system of regular monitoring and financial aid – aim to restore market confidence and facilitate the country's return to financing itself on the market. The eurozone lacked a mechanism similar to what the IMF had to deliver aid quickly to distressed countries. The aid package for Greece was financed with bilateral loans from member countries that had been negotiated with great difficulty. Repeating the exercise for another country would have been very complex. The euro was in danger as long as the EU lacked an efficient institutional mechanism able to deal with a member country's crisis.

In early May there were two ways to confront the growing market tensions. The first entailed the European Central Bank buying government bonds of troubled countries – mainly Greece, Ireland

and Portugal – to counter the market instability. The central bank would thus become the buyer of last resort of government bonds that the market did not want. This would guarantee stable financial conditions that would calm investors and convince them to continue buying government bonds. This would, however, have distorted the central bank's role. In financing member countries' debt, the ECB would be violating the provisions of its statute prohibiting monetary financing of governments. At the same time, the central bank would be failing to fulfil its role of promoting price stability. In addition, by providing funding on favourable terms the ECB would have taken away any incentive governments might have had to consolidate public finances and control their debt.

The alternative was to do nothing and leave it up to the governments to resolve the situation. However, without the central bank's intervention the instability of the financial markets would have increased, leading to contagion thereby compromising the very objective of the ECB's monetary policy, which is price stability. Increasing interest rates on medium- and long-term bonds would have had a recessionary effect on the economy and jeopardised the recovery.

The advantages and disadvantages of the two options were carefully evaluated ahead of the decisions taken in the first week of May 2010. With the increasing tensions on the financial markets, there was a widespread belief that only the intervention of the central bank could keep the worst from happening. The negotiations between eurozone countries for the creation of a European monetary fund were proceeding slowly and the differences seemed too large to bridge in a short period of time.

On May 6th, the ECB's Governing Council met in Lisbon, one of the two meetings held each year away from the Frankfurt headquarters. In the press conference following the meeting a journalist asked Jean-Claude Trichet, President of the bank, if the Governing Council had decided to intervene in the government bond markets of countries under pressure. If he had replied in the affirmative the markets would have stabilised, at least for a while, but the governments would have postponed indefinitely the creation

of the European fund. If he had answered in the negative, the financial markets would have panicked. Trichet chose a middle road, responding simply, “we did not discuss it”. The goal was to keep the pressure on governments to accelerate the creation of the fund.

Trichet’s statements created concern in the markets beginning on the afternoon of May 6th. The same evening, members of the ECB’s Governing Council still in Lisbon gathered informally to decide how to react to the market deterioration and how to interact with the governments. After a long discussion a consensus was reached to intervene in the government bond markets of the three countries in trouble, but only after the governments had decided to create a new institution to provide financial support to distressed countries and only for the amount of time necessary to make the new institution operational. The ECB’s intervention was only supposed to buy time to allow governments to create a definitive safety net.

On May 7th, the heads of government meeting in Brussels again sought to put pressure on the central bank to intervene on the markets. Trichet refused, pointing out that it was the government’s responsibility to create an instrument capable of solving the problem. At that point, the heads of government agreed to create the bailout fund.

Sunday, May 9th, the European Central Bank decided by majority vote to intervene in the government bond markets of Greece, Ireland and Portugal. The ECB did not publicly announce its decision until after European ministers ratified the practical aspects of their agreement in the early hours of Monday, the 10th, shortly after the opening of Asian markets.

The ECB’s intervention helped calm markets and the spreads between various government bonds quickly declined. If the ECB had intervened earlier, the governments would probably have put off the decision to create the bailout fund. If it had not intervened at all, the financial markets probably would have collapsed on the morning of May 10th. That weekend the central bank’s role changed radically. The ability to push government authorities to make decisions contrary to their immediate desire gave the bank an unexpected

political role. No other central bank in the world has this power and no other was as equally frustrated at having to use it.

The European markets had a period of relative calm after these events in early May 2010. This phase, however, was not exploited to strengthen the financial system or to speed up the adjustment process. Instead, a feeling of calm was spread. National authorities carried out stress tests to assess the health of their banks, but the tests were not coordinated among countries and were done using different assumptions. The publication in July 2010 of the results, done only under pressure from the markets, revealed the extreme differences between the tests of the various countries and consequently their unreliability as a tool for evaluating systemic risk. The markets soon came to believe that the problems of the European banking system were far more serious than what had been made public.

The ratification of the bailout fund by the member countries took six months, much longer than expected, and it was not clear all countries were committed to making it a reality. Without ratification by all countries, the whole plan risked collapsing and that is almost what happened. Slovakia, in particular, decided to ratify the plan only under intense pressure from other countries, especially Germany. Moreover, the ratification process was superimposed on negotiations to transform the fund into a fixed mechanism to be included in the treaty. The negotiations took an unexpected turn when some countries began to suggest that private creditors should also be penalised whenever the fund helped a country. In the midst of the financial crisis this principle, enshrined in the Deauville accord between Merkel and Sarkozy, generated strong doubts in financial markets that the European leaders could handle the situation.

The period of calm in the financial markets that followed the ECB's intervention in May 2010 led the distressed countries to postpone their adjustment measures. In Ireland, the government refused to anticipate the 2011 budget despite the demands of the international community and the impact on the public finances of the banking system's increasing difficulties. Irish banks had lost access to financial markets and could finance themselves only through the

central bank. The Irish government agreed to bring forward the budgetary procedure and carry out an adjustment plan partially financed by the International Monetary Fund only after the ECB said in November 2010 that it would no longer fund the banking system without an adjustment programme agreed to with the EU.

Portugal also tried to put off the adjustment until after the elections scheduled for June 2011. Despite the central bank's interventions, conditions worsened in the spring of 2011, partly as a result of contagion from the Greek crisis. Portugal managed to find a bipartisan agreement before the election that was signed by all parties and bound them to the same restructuring programme.

The same scenario was repeated in the summer of 2011 when governments delayed enacting reforms after the new ECB intervention to stabilise the financial markets.

The financial markets entered a new phase of instability in July 2011 as a result of the Greek debt restructuring and unconvincing decisions taken by the European Council to strengthen the bailout fund. The markets began to sell massive amounts of Italian and Spanish government bonds, pushing interest rates to very high and potentially unsustainable levels. The bailout fund did not have sufficient funds to finance eventual programmes for the two countries. Only the European Central Bank's intervention could keep interest rates and public debt from spiralling out of control, which would have further worsened the credit crunch during the recession. However, the central bank was concerned that as with Ireland and Portugal, its intervention would delay the structural changes and public finance adjustments that were necessary to reduce the imbalances in both countries.

After a long discussion, on 5 August 2011, the ECB's Governing Council decided to ask the two countries for specific commitments on structural reforms and public finances. The ECB would intervene on the markets to stabilise the yields on government bonds only if these commitments were publicly accepted. The commitments, requested with two confidential letters, were accepted publicly by both governments within a couple of days. The details of the measures were communicated to the central bank over the weekend.

The decision to intervene was made over the weekend of August 8th, but it was not unanimous. Some members of the Governing Council were not convinced that the commitments would be respected. Others requested a new letter be sent asking for more details on the measures that had been announced. The central bank began to intervene on August 9th, significantly reducing the interest rate differentials and restoring market stability. However, in Italy the implementation of the public finance measures was called into question in the following weeks, in particular during the parliamentary debate preceding the conversion of the government decree into law. The measures were changed several times, and in some cases watered down. The government did not follow through with the requested structural reforms relating to pensions, the labour market and liberalisations, which were deemed necessary by both the central bank and financial markets to ensure the sustainability of Italy's public finances. Once again, the calm in the financial markets that had been gained with the central bank's intervention had pushed the governments to postpone the most urgent decisions.

As governments got used to the ECB intervening, the central bank's credibility risked being undermined. This made it more difficult to create a consensus within the bank for new measures should they be needed. The interventions were progressively reduced during autumn 2011 despite the resurgence of pressure that brought interest rates back to very high levels, particularly in Italy.

The sleep-inducing effects on governments of the ECB's interventions explain why during a new phase of financial market tension in the summer of 2012 the central bank announced it would intervene to save the euro only on the condition that the countries submitted themselves to restructuring programmes agreed to with international institutions. The conditionality of the interventions saved the ECB from having to tell a country directly under what conditions it was prepared to buy its government bonds on the market, as had happened in the case of Italy and Spain in 2011. The announcement on 6 September 2012, about the new monetary policy instrument (the OMT) reflects the central bank's decision to shed the political role of having to establish the conditions under which it

would intervene to avoid the risk that a country would have to leave the euro. That role lies with the EU's political institutions. Only when these conditions are met can the central bank use all the tools at its disposal to ensure the irrevocability of the euro.

The ECB's announcement had such a strong effect on the markets, in particular on the interest rates in Italy and Spain, that both countries decided it was no longer necessary to resort to an adjustment programme coordinated by the European institutions and the International Monetary Fund. It was not understood that the central bank's announcement would only have a temporary effect, buying time for the governments to put in place the structural and financial measures needed to reduce imbalances accumulated in the past. But if these measures are not put in place quickly, sooner or later the market tensions resume and intensify thereby putting the profligate governments under pressure. At that point the central bank cannot buy any more time for the governments.

20. SOVEREIGNTY BELONGS TO THE PEOPLE

Sovereignty belongs to the people, that is until incompetent politicians cede it to financial markets and international institutions. When so much debt is issued that it must be sold to international investors, the economic policy decisions no longer depend only on the will of the people, but must also take into consideration the financial markets' willingness to buy that debt. A country loses its sovereignty when it loses the confidence of investors.

One of the main dynamics of the European crisis and one of the reasons why it lasted so long is the tendency of those who govern to dump the blame on others for the crisis and the inability to solve it. The favourite scapegoats are generally financial markets, foreign banks, creative financing, the ratings agencies and European institutions. They are all easy targets because each of them played a role in the crisis. However, it becomes problematic when the move to find a scapegoat leads to denunciations of a loss of popular sovereignty because it not only misrepresents reality, but because it also diverts attention from the real problems faced by people, especially in distressed countries.

It began with blame being attributed to the crisis in the United States and the collapse of American investment banks that had increased their leverage and sold opaque debt instruments. The American financial system had in fact grown too large as it took advantage of the relaxation of regulations brought on by a wave of liberalisation initiated in the 1980s by the Reagan administration and continued during the Clinton years. In his book *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Raghuram Rajan explains how financial deregulation benefited all sectors of American society including the financial system, poor families who got easy access to debt, students thanks to the exponential growth of student loans, the real estate sector and those who benefited from increased consumer spending. The Federal Reserve's policy of low interest

rates also favoured strong consumer spending. Moreover, the growth of domestic demand and the profits made by the financial sector led to higher tax revenues for the state and allowed for tax cuts.

The favourable regulatory conditions and macroeconomic policies contributed to raising indebtedness, particularly in the private sector, in the expectation that stronger growth and the persistence of low interest rates would make it easier to service the debt. The bursting of the housing bubble and contagion in the financial system dramatically reduced access to credit and forced an adjustment in the savings rate of American households and companies.

The American subprime crisis was transmitted to Europe not only because the continent's financial system had invested heavily in American junk bonds, but also because many eurozone countries had themselves accumulated too much debt. Debt was not only accumulated by the public sector, as in the case of Greece, but also by households and businesses, as in Spain and Portugal, and the banking system, as in Ireland. In ten years these countries accumulated debt owed to non-residents equivalent to approximately 100% of gross domestic product.

The risks associated with the excessive accumulation of debt were long underestimated in Europe because financial transactions were denominated in euros, the same currency used by those granting the credit. The current account deficits were not considered problematic because it was assumed they would be easily financed like in the United States. An important difference was forgotten. In the United States the risk of excessive debt taken on by businesses and households in a particular state is diluted over the entire US financial system, which is fully integrated.

In Europe, however, domestic banks are the main lenders to the residents of their country. When the residents have difficulty repaying their debts, banks in that country are the first to suffer. The bursting of the Spanish real estate bubble, for example, has primarily impacted Iberian banks. When banks have problems in the United States and must be recapitalised with public funds, the intervention takes place at the federal level and it is therefore shared by all

taxpayers. In Europe, however, only the taxpayers of the country where the bank resides are on the hook. An excess of private debt becomes a problem for a country's banking sector and given the sector's size results in too much public debt. When a country's sovereign risk increases, foreign investors reduce their exposure not only to the public sector, but also to all the residents. When the yields on a country's government bonds grow due to the increased risk, it becomes more difficult for households and businesses to find financing, thereby forcing the economic system into a painful adjustment process.

At that point, the country needs to change course and the recovery of market confidence becomes the priority, given the necessity to continue tapping international investors to finance the debt. This requires the adoption of measures that are unpopular with both the people and those in power, but necessary in order to be able to continue to issue debt. Sovereignty is not unlimited in the field of economic policy. It depends on the ability to access financial markets. If that access is in the balance, the range of choices available to governments is drastically reduced.

Financial markets are often procyclical, underestimating the risks when market conditions are favourable and overestimating them when fear or instability prevails. Before the crisis, financial markets for a long period considered the risk of an investment in Spanish or Italian government bonds to be similar to that of an investment in German bonds. In hindsight, this was incorrect. Markets were too optimistic about the ability of countries on the periphery to control their public finances, especially during a systemic crisis. Perhaps the markets also thought that in the event of difficulties the treaty's no-bailout clause would not be respected. Whatever the reason, the markets financed all the eurozone countries with almost the same risk premium.

The problem is that not all countries exploited equally the stability in the financial markets that followed the launch of the euro to clean up their public finances. To demonstrate this, it is useful to compare the cases of Italy and Belgium.

In 1997, Belgium had public debt equal to 122% of GDP, a deficit of 2.3% and a primary surplus (budget surplus excluding interest payments on debt) of 5%. Italy had very similar numbers: less debt than Belgium (117% of GDP), a deficit of 2.7% and a primary surplus above that of Belgium (6% of GDP). In the following years and until the outbreak of the crisis, Belgium maintained a primary surplus constantly above 4%, which allowed it in ten years to reduce debt by nearly 40 points to 84% of gross domestic product. In Italy, however, the primary surplus fell following the entry into the euro and reached zero in 2005. It bounced back to 3% of GDP in 2007. In ten years, the public debt was reduced by only 14 points, less than half of what Belgium accomplished, reaching 103% of GDP, thanks in large part to the sale of public assets. After the outbreak of the crisis, Italy's public debt rose by more than 20 percentage points to above 125% of GDP in 2012, while Belgium's debt remained below the 100% threshold.

The differing trends in public finances partly explain why financial markets dragged Italy into the crisis while ignoring Belgium. The markets evaluated positively Belgium's greater ability to control public finances, despite domestic political difficulties linked to the relations between the country's two main regions. This prevented an excessive widening of interest rates. If Italy had followed a consolidation path as rigorous as that of Belgium after the entry into the euro, then it probably would have been spared by the crisis.

Financial markets do not assess a country's risk only on the basis of fundamentals. They also take into account the contagion that may arise from systemic events, such as another country's exit from the euro and the chain reaction that can pull one country after another into instability. After the Greek debt restructuring in June 2011, the differentials of all the countries considered at risk increased whenever the Greek situation worsened and endangered the euro. Conversely, whenever a favourable outcome seemed possible, a wave of optimism engulfed the financial markets and improved the situation for all countries. For example, after ECB announcements of extraordinary actions, such as in the summer of 2012 when the bank

said it was ready to make unlimited purchases of bonds, the risk of dramatic events declined and the beneficial effects were felt above all by those countries most at risk.

Even though the risk of the euro collapsing declined somewhat, especially following the ECB's announcement and the outcome of the elections in Greece, interest rates on government bonds are unlikely to converge as dramatically as they did in the first years of the euro. Although financial markets long ignored the growing differences between countries, it is hard to imagine them being so short-sighted again. This is all the more so as fundamental data continue to show a big divergence among the countries.

Picking up again the comparison between Belgium and Italy, the IMF forecast in the spring of 2013 that Italy's public debt is expected to rise in 2013 to over 130% of GDP and then begin declining in subsequent years, although remaining above 120% until 2018. Belgium's debt is forecast to fall faster and should be back at about 90% of GDP within five years. These forecasts consider not only expected changes in revenue and public expenditure, but also economic growth, which in Italy is expected to be weak just as it has been in the past decade. Also, while Belgium is basically in the black on the current account side of the balance of payments, that is to say it is a net saver that exports capital, Italy is expected to run an external deficit and therefore continues to need international capital inflows.

When a country needs public or private savings from the rest of the world to finance its debt, the primary goal of economic policy will inevitably be to ensure investor confidence. Consolidation measures are in effect submitted to the markets for scrutiny and it can be argued that this is a loss of sovereignty. But if a country's financing is at the mercy of the markets, it is not the fault of the markets, but rather of those who led the country to have excess debt and consequently an increased risk profile.

The distinction between international and domestic markets should not be pushed to the extreme. Even if a country's entire debt is held by its residents and consequently there is no need for net inflows from the rest of the world, economic policy must still take

into account the confidence of domestic investors. Even if those investors have a bias for investing in their own country's debt, the possibility that they can move their savings abroad limits the ability of governments to take oppressive measures. Italians remember well the summer of 1992 when in their bank accounts were taxed, which fuelled capital flight and accelerated the crisis of the European Monetary System. In an integrated financial system, residents can also quickly sell the government bonds held in their portfolio. It is understandable that those who govern are tempted to lay all the blame for the crisis and the excessive rigour of the adjustment on financial markets. This is done to avoid taking responsibility for past economic policy mistakes and to blame others for unpopular decisions that must be taken. It is less understandable that citizens, commentators and the media – those who must keep the government accountable – also succumb to this temptation.

When this happens, there is indeed the risk that popular sovereignty will be manipulated.

21. CONCLUSIONS

The European crisis is part of a wider crisis that is hitting the most economically advanced countries across the globe. Although it has manifested itself through an excess of public and private debt accumulated over the past years, debt is just a symptom of the crisis and the actual cause is much deeper. The crisis is connected to the changes that have engulfed the world economy in the last 20 years and called into question the western world's growth model and the sustainability of its social systems. In addition, power has gone through an increasing fragmentation in Western democracies, as suggested by Moises Naim in his *The end of Power*, "creating a situation where gridlock and the propensity to adopt minimalist decisions at the last minute are severely eroding the quality of public policy and the ability of governments to meet voters' expectations or solve urgent problems". Those who did not notice these changes, or chose not to notice them, and continued to act individually and as a society as if nothing had changed were able to do so only by borrowing. The adjustments that needed to be made were postponed until it became impossible to delay any longer because the financial markets were no longer willing to finance further debt. At that point there was the choice of treating the symptoms - the excessive debt - through the adoption of traditional macroeconomic policies, or instead facing the deeper causes of the crisis with structural reforms aimed at adapting the economic and social system to the new global context.

The second way, making the reforms, is politically more costly because it requires moves that call into question rights that powerful groups or even the majority of the population have acquired through time and now consider untouchable. The precarious situation of public finances has made it no longer possible to compensate those directly hit by the reforms. During a crisis, when the confidence of

investors has been lost, governments are tempted to treat the symptom rather than the disease. In an emergency situation, it is easier to get the population and political parties to back drastic changes to public finances rather than enact profound changes to the economic system, which consequently get delayed.

The austerity measures decided in an emergency are the result of the inability of democratic systems to address in a timely manner and with adequate measures the problems gripping the advanced countries. The cure, however, is not effective because it does not solve the underlying problems and risks being worse than the disease. Austerity generates discontent and fuels disruptive forces in society, contributing to the emergence of populist movements and endangering democracy itself.

This is not a theoretical risk. Argentina's experience in the 20th century shows that in a few decades a country can slide to the bottom of the global economic system while still thinking that it is at the apex.

How can the course be reversed? There are two roads. The first is to buy even more time until the economy starts growing again, at which point the underlying problems can be addressed under more favourable conditions. The second is to intervene immediately without postponing the most difficult decisions.

One way to buy time is to keep following the strategy adopted so far, waiting for the moment when the pressure from the financial markets makes it clear to everyone that the alternative is worse. This strategy has produced some positive results in recent years as many countries began to correct their accumulated imbalances when they found their backs to the wall. This strategy also led to significant progress in strengthening the monetary union with the creation of the bailout fund, the banking union, the fiscal compact and the intensification of macroeconomic oversight.

Making decisions with your back to the wall is a dangerous strategy because those decisions are generally not very effective and focus on the symptoms rather than the cause. One also cannot assume that democratic choices are always 'rational', especially at critical moments. The risk that populist promises amounting to

nothing more than a leap in the dark will be followed cannot be underestimated. In 2012, the Greeks got very close to exiting the euro, a decision that would have had dramatic effects on the country's social and democratic cohesion. The history of the 20th century has shown that European democracies are not alien to making suicidal choices, especially during periods of economic depression.

Decisions made under pressure from the markets will eventually be seen by the public as an external imposition that threatens the sovereignty of the people. How many times has the rally cry been raised against the dictatorship of the financial markets? Interventions made by supranational institutions are also seen as interference in internal affairs. Blame is assigned to scapegoats, often external ones such as the EU, that are seen as authoritarian figures sent in to impose their will rather than help.

A second way to buy time is to add the costs of the excessive debt accumulated in the past to the public finances and postpone adjustment measures until the economy improves. This is only possible in countries that can still borrow at reasonable rates. The national central bank can be called on for help when markets are no longer willing to buy government bonds. This is a disguised way of shifting the cost of the adjustment to future taxpayers who will have to deal with higher inflation, while providing the public funds necessary to compensate for the central bank's losses. It is convenient for the government to ask the central bank to print money as this allows the adjustment to be done with a tax, i.e. via inflation, which does not have to be voted on in parliament. The central banks that oppose this sort of intervention on the ground that it goes against their mandate are subjected to political pressure and calls to reduce their independence.

Buying time can be useful only if in the meantime concrete measures to address the structural problems are enacted. If the measures are not taken, the conditions are created for new financial excesses and speculative bubbles generated by low interest rates. The bubbles will burst sooner or later, bringing down the markets with them and causing recessionary effects on the economy. Flooding the

markets with liquidity is useful only if it helps the system reduce its debt gradually and without excessive shocks to economic activity. If, instead, the liquidity leads to the postponement of the adjustment measures, it will create the conditions for a rapid emergence of a new crisis.

The alternative is to take the bull by the horns and immediately implement the reforms necessary to better equip the economic system to cope with the evolving global changes caused by market integration, technological innovation and the aging of the population. This last point is especially relevant in Europe. The countries that enacted their reforms in time, particularly those in Northern Europe, were able to absorb the crisis better and also reduce unemployment.

The problem, as previously mentioned, is that reforms are politically costly and penalise those who promote them. Asking those who govern to take the long view and not be influenced by short-term interests is intellectually stimulating, but unrealistic. Gerhard Schröder reformed Germany, but lost the election. It is an example that only a suicidal politician would try to emulate. Those who govern are motivated by incentives, chief among them the desire to be re-elected, a legitimate goal in a democratic system and something that has not been achieved by almost anyone in Europe in recent years. It is useless to say “there are no leaders like there used to be”. Those leaders were living in a different context, characterised by a trend of increasing income and population. Combining growth and equality was possible at the time without damaging either.

The change in the global context and demographic trends created a new tension between short- and long-term choices. Those who govern are encouraged to give ever-more importance to immediate results and ever-less consideration of the long-term horizon. This paralyses the decision-making system and spreads the dangerous thesis that democracies are not able to manage the crisis and are doomed to decline.

To strengthen democratic systems, it is necessary to create incentives to make decisions with a longer-term outlook. This can take place in a European context that is able to provide a coherent

framework for national decision-making mechanisms while comparing experiences and models. The periods of maximum development in Europe have occurred above all when the continent's differences were free to express themselves in a system of cooperation and competition that extended not only to companies and economic systems, but also to methods of government. The preservation of this diversity within an increasingly tight political union helps guarantee the future of European democracy.

What follows are some points for reflection.

The first point concerns the need for Europeans to become fully aware that the European model of economic development and the welfare system created during the 20th century is no longer compatible within the new global context. This is not easy to accept because it is human nature to look to past trends as a guide for future behaviour. Structural changes are generally picked up on late, especially when they are epic changes that require a big adjustment. It is not, however, always in the interest of those who govern to bring to the collective attention the need to change course because it is politically costly to implement the policies necessary to deal with change. Those who govern are often tempted to minimise the problems in order to continue maintaining their consensus among the voters. If public opinion is not exposed to alternative ideas and a broad understanding of the global context, it is unlikely people will understand the nature and extent of the problem. The media plays a key role in this regard. A democracy in which the media are subjected to various forms of influence by those in power or elites close to them tends to lose sight of the bigger picture and lends more importance to short-term interests. The so-called fourth estate cannot play its role as 'guard dog', which is essential for the proper functioning of a democracy, if the owners of the media have economic interests linked to the public sector. Without a clear separation between the media and economic and political power there is an incentive for the means of communication to minimise difficulties, thereby creating a high risk that public attention will be diverted from the real problems.

The problem affects not only individual countries, but also the European Union given that there is no transnational system of information or means for exchanging opinions. People are informed through their national media, which tend to distort reality, especially with regard to European issues. The summits between the heads of government, for example, become an opportunity for political leaders to demonstrate to their respective publics their ability to influence EU decisions. The media represent results as a victory for one and a defeat for another as if it were a football match. The idea that decisions should be made for the common good gets lost along the way. Sometimes the well-orchestrated press conferences that take place after EU meetings make public certain information that completely distorts the way the discussions actually went. There is a risk the information will be manipulated unless those who report the news carefully scrutinise everything. The newspapers sometimes try to exploit nationalist sentiment, as was seen in Germany and Greece during the most acute phases of the crisis. It is easy to lay blame for the national failures on the leaders of the other countries.

The second point regards the independence and oversight of the institutions tasked with providing essential input that governments use to set economic policy. For example, over the last 15 years industrialised countries have systematically overestimated economic growth, generating overly optimistic expectations for tax revenues. This led governments to correct the shortages with measures on the revenue side rather than on the expenditure side, thereby further stunting growth. Growth forecasts used to set economic policy should be made by independent bodies that are subjected to transparent oversight, as is the case in the Netherlands and Sweden.

Politicians have increasingly tried to influence central banks, which have the job of implementing anti-cyclical measures to counter the volatility of the financial markets and the economic systems. The current crisis showed the potential for monetary policy to save governments, but also the risk that policy can be manipulated for short-term purposes. In some countries like the United States and Japan, a dangerous shift is occurring in which some people try to

bring the central bank under the government's influence. This is presented as a new paradigm of monetary policy, which should be given new duties. In several European countries, there is a call for "the ECB to act like the Federal Reserve", becoming the lender of last resort for governments. Those making this appeal forget that in the United States the central bank does not intervene in the bond markets of the various states, nor does it buy municipal bonds.

The independence of central banks should instead be strengthened, not only because of the importance of monetary policy, but also because of the role the banks play in banking supervision. These key areas are often subject to political interference. Giving the responsibilities for competition or banking supervision to European institutions reduces the influence of domestic politicians and lobbies, thus avoiding the pursuit of only short-term interests.

A third point concerns the constitutional constraints that limit the margin of discretion of an excessively short-term economic policy. This is the objective of the fiscal compact, which pushes fiscal policy towards a medium-term outlook that is in the interest also of future generations. The objective of debt reduction must be a priority for the overly indebted countries that have a quickly aging population, not only because it creates the conditions for more sustainable growth, but also because it avoids passing the burden onto the weakest parts of society, in particular young people who are a minority in most European countries. Not surprisingly, in high-debt countries such as Italy, political forces of all stripes have asked for a relaxation of the fiscal compact's rules. Without a doubt rules should be interpreted, but not in a way that jeopardises the sustainability of public debt or facilitates manoeuvres that are not consistent with maintaining equilibrium in the medium term. The comparison between the experiences of Italy and Belgium during the first years of the euro, discussed in chapter 20, shows that a policy of continuous reduction of the public debt decreases the risk of contagion in the event of a financial crisis and favours faster economic growth.

Incentives should be created to move the focus of economic policy from fiscal considerations to structural ones. The European

system for monitoring macroeconomic imbalances adopted in 2011 appears to be as weak as the Lisbon process. A discussion has started about the possibility that European countries could reach bilateral contractual agreements with the European Union aimed at getting financial support in exchange for structural reforms.

The responsibility for implementing structural reforms ultimately lies with individual governments and the people of the various countries. It serves no purpose and can actually be counterproductive to ask Europe to solve problems that result from the inability of national political systems to modernise their economies. When financial aid is requested, European institutions can attach specific conditions, including a call for structural changes, so as to avoid contagion. Otherwise, responsibility rests with national institutions and the weaker they are the greater their tendency to postpone difficult choices. Waiting until the last minute to make difficult decisions is an ineffective and potentially dangerous strategy. When problems are left unresolved for a long time and people grow increasingly aggravated, the relative cost of irrational choices decreases and the risks posed by leaps in the dark increases. Countries that do not have strong institutions that protect them from these risks are the first to head down the road of economic decline.

One last point of reflection concerns the impact of demographic trends on economic policy choices. With an aging population, there is an increased tendency to seek short-term solutions and to postpone the adjustment. As time passes the share of electors that have an interest in defending what are considered acquired and permanent rights increases. This shifts the burden to the younger generations, which are a political minority and are left to pay for the privileges enjoyed by the majority. The result is a rejection of politics as evidenced by the high percentage of absenteeism and the large number of votes obtained by populist parties in recent elections, in particular in Italy. Until now, the risk this development poses for the survival of European democracies has been underestimated.

All of these objectives can be pursued both at a national and European level. The crisis showed that to avoid excessive

divergences between countries and allow Europe to cope with the shocks that risk tearing it apart, more steps must be taken to complete the economic and monetary union. Further progress in adapting institutions is necessary to strengthen the EU's decision-making apparatus while simultaneously increasing its democratic legitimacy.

All countries, perhaps with the exception of the United Kingdom, pay lip service to being in agreement, but the facts show that the first to oppose tighter integration are national politicians who do not want to lose their powers. They rebuke Europe for not making decisions, forgetting that they are the ones who do not want Europe to decide. European institutions are given more powers only when the countries are confronted with a crisis and it is obvious that it is not possible to resolve the problems at the national level.

It is no wonder that Europeans feel Europe is detached from their everyday life and express doubts about ambitious institutional projects. The rejection in 2005 of the European constitution in France and the Netherlands is still smouldering. Hoping that new European leaders will launch a similar project in the near future risks creating unachievable goals. On the other hand, there are clear limits to continuing with a gradual integration of tasks that are being carried out ineffectively at the national level. The bailout fund, for example, entails complex, largely intergovernmental decision-making procedures that reduce its effectiveness and exacerbate tensions among countries. Doubts about democratic legitimacy have become evident with the emergence of more and more problems linked to a lack of consistency among European institutions.

Maybe the best way to strengthen the political union is to start with the question of democratic legitimacy. It is interesting to note that this problem is a critical issue for both eurosceptics who want to leave the EU, such as the Conservatives in the UK, and federalists who are willing to cede national sovereignty only to fully democratic institutions. This is often noted by the German constitutional court in its opinions. Both groups believe - rightly or wrongly - that the European Parliament is not sufficiently representative of the popular will and has no powers to adequately control the executive power

held by the European Commission. Without a strengthening of the European Parliament, which represents the common interests of the people across the member countries, European integration will not be achieved. Boosting its power will require difficult battles, which are already on the horizon, because member states' governments are the staunchest opponents.

The journey's difficulties may seem insurmountable, but European history of the last 60 years shows they can be overcome. Just five years ago it seemed unthinkable that the EU would have taken the steps that it has managed to take during the crisis (granted they were carried out in a disorderly manner and several times the EU risked stumbling). The path is still long. But not even the United States of America was created in a day, or even in a century.

CHRONOLOGY

2009	
<i>4 October</i>	George Papandreou, the leader of Pasok, defeats out-going Prime Minister Kostas Karamanlis in the Greek elections.
<i>16 October</i>	The new Greek government announces that the deficit will be more than 10% of GDP in 2009. Two weeks later, the forecast is raised to 13%.
2010	
<i>14 January</i>	The Greek government presents a plan to reduce the deficit to 2.8% of GDP in 2012.
<i>13 March</i>	At a bilateral meeting, Merkel and Papandreou announce that "Greece does not need aid" and "Greece will not request aid".
<i>25 March</i>	European Heads of state say they are ready to initiate a programme of aid for Greece in cooperation with the International Monetary Fund.
<i>2 May</i>	Following a request by the Greek government made on 23 April, eurozone countries and the IMF announce a €110 billion aid package for Greece.
<i>6 May</i>	The European Central Bank, meeting in Lisbon, says it did not discuss intervening to buy the bonds of member states. In the afternoon, financial markets suffer big declines.
<i>7 May</i>	The heads of government of eurozone member countries announce a strengthening of macroeconomic supervision and a package of measures to ensure the stability of the euro.
<i>9 May</i>	Eurozone finance ministers announce the creation of the bailout fund, which has €500 billion available. The European Central Bank's Governing Council decides to intervene, buying Greek, Irish and Portuguese bonds.
<i>10 May</i>	The ECB buys bonds with an immediate effect on the spreads.

<i>23 July</i>	The first results of the European bank stress tests are published. Only seven banks are found to be under-capitalised by a total of €3.5 billion.
<i>29 September</i>	The European Commission presents its proposals to reform the Stability and Growth Pact (the 'six pack').
<i>18 October</i>	Merkel and Sarkozy, meeting in Deauville, agree to a series of measures to create a permanent bailout fund that includes private sector involvement.
<i>28-29 October</i>	The heads of state accept the Merkel-Sarkozy accord on the bailout fund with the opposition of Trichet, President of the European Central Bank.
<i>28 November</i>	Eurozone countries agree to an aid programme for Ireland worth €85 billion.
<i>16-17 December</i>	The heads of state change the law on the involvement of the private sector, as requested by the central bank, and adopt the decision on the European Financial Stability Facility, which will become effective in 2013.
2011	
<i>25 February</i>	Enda Kenny, leader of the opposition party, wins the Irish elections and becomes prime minister.
<i>11 March</i>	Some modifications are made to the Greek debt restructuring programme, including a cut in interest rates and a lengthening of due dates. It is also decided that the bailout fund can intervene on the market buying government bonds.
<i>April</i>	Rumours spread about an imminent restructuring of Greek debt. Standard and Poor's, the ratings agency, estimates the face value of the bonds will be cut by 50-70%.
<i>17 May</i>	Eurozone countries decide on a €78 billion programme of aid for Portugal that is signed by all of the country's main parties before the election.
<i>5 June</i>	The opposition party, headed by Pedro Coelho, wins the Portuguese election.
<i>15 July</i>	The results of the second stress test on the European banks are published. The markets are unconvinced by the results.
<i>21 July</i>	The heads of state agree to a new programme of aid for Greece that includes another €109 billion (that are added to the €130 billion previously agreed to and the restructuring of Greek debt held by private investors, which will be voluntary

	and will reduce the value of the bonds by about 21%. It is also decided to make the bailout fund more flexible by allowing it to take precautionary measures, intervene on the secondary market and contribute to the recapitalisation of banks.
<i>5 August</i>	The central bank writes to the Italian and Spanish governments to ask for the implementation of structural reforms and fiscal measures to calm the markets.
<i>7-8 August</i>	The Italian and Spanish governments announce a series of consolidation measures.
<i>9 August</i>	The ECB decides to intervene by buying Italian and Spanish government bonds.
<i>6 September</i>	The Swiss central bank puts a ceiling on the exchange rate between the Swiss franc and the euro.
<i>4 November</i>	At the G20 in Cannes, Merkel and Sarkozy reject Papandreou's proposal that Greece hold a referendum on the euro. Berlusconi accepts a strengthened programme to monitor Italy's commitments to carry out fiscal and structural reforms, but rejects a formal adjustment programme.
<i>8 November</i>	Berlusconi resigns as Prime Minister of Italy.
<i>9 November</i>	Papandreou announces his resignation as Prime Minister of Greece. He is replaced two days later by Lucas Papademos.
<i>13 November</i>	Monti is nominated to be Italian Prime Minister.
<i>20 November</i>	Rajoy's People's Party wins the Spanish election.
<i>8-9 December</i>	European heads of state (with the exception of those of the UK and the Czech Republic) agree to a modification of the Stability and Growth Pact to incorporate fiscal rules in the national constitutions (fiscal compact) and to strengthen the bailout fund.
<i>8 December</i>	The European Central Bank enacts a series of measures to make liquidity available to the banking system including three two-year fixed-rate refinancing operations.
2012	
<i>30 March</i>	Eurozone finance ministers agree to boost the bailout fund to €700 billion.
<i>6 May</i>	François Hollande wins the French presidential elections.
	Antonis Samaras' conservative party, New Democracy, obtains the most votes in the Greek election, but is unable to form a coalition to govern.

<i>7 May</i>	The Spanish government decides to nationalise Bankia and in the days that follow adopts a series of measures to strengthen the banking system.
<i>17 June</i> <i>25 June</i> <i>28-29 June</i>	In the new Greek elections New Democracy obtains 30% of the vote and Antonis Samaras becomes prime minister of a coalition government with the socialists. Cyprus requests aid from the bailout fund. Eurozone countries agree to form a banking union with integrated oversight. The European Council adopts the Growth Pact and tasks the presidents of the European Council, European Commission, Eurogroup and the central bank to draw up a roadmap for the realisation of a full economic and monetary union.
<i>26 July</i>	In a speech in London, the President of the European Central Bank says “the ECB is ready to do whatever it takes to preserve the euro (while still respecting its mandate)”.
<i>7 August</i>	Juncker, President of the Eurogroup, which includes the finance ministers of the eurozone countries, says a Greek exit from the euro “would be manageable, but that does not mean it is desirable”.
<i>6 September</i>	The central bank announces a programme of outright monetary transactions to buy bonds for a potentially unlimited amount provided the countries whose bonds are being bought adopt an adjustment plan.
<i>9 October</i>	While on a visit to Athens, Merkel says she “hopes and wishes” that Greece will stay in the euro.
<i>27 November</i>	Eurozone finance ministers decide on a series of measures to soften the conditions of Greece’s adjustment programme – reducing interest rates, extending maturity dates and introducing a programme to buy the country’s debt.
<i>10 December</i>	Monti announces his resignation as Italian Prime Minister.
<i>13 December</i>	Eurozone finance ministers decide to create a system for unified banking supervision in eurozone countries that will be run by the European Central Bank.
<i>14 December</i>	The heads of state adopt a roadmap for the realisation of a full economic and monetary union.

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