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Institutional Setting, Structural Vulnerability, and Policies

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The Eurozone Crisis:
Institutional Setting, Structural Vulnerability, and Policies

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Abstract:

The unfolding of the crisis in the Eurozone can be explained by the interaction of institutional features and policy failures, and by their interconnection with real and financial imbalances. The crisis has shown that internal divergence in the EZ is based on important structural components which are unsustainable in the long run. Indeed, the crisis has magnified the gap between the vulnerable peripheral member countries and a more resilient core. The paper analyses those factors that opened the way to the diffusion of the financial and economic crisis in the Eurozone. It also discusses the structural consequences of these events and critically analyses the institutional and political reforms which the Eurozone is facing in order to enhance its capability to cope with external shocks.

Keywords: Eurozone; European Union; European Monetary Union; euro; Common fiscal parameters; Real convergence; Productivity

JEL codes: P16; O10; E60

1. Introduction

The international crisis has hit hard the Eurozone (EZ) and shows remarkably distinct patterns among its countries. The EZ, and hence the Euro, has shown to be highly vulnerable to external shocks, suffering of deep-seated as well as new structural and financial imbalances. At the same time, the EZ's ability to cope with its economic vulnerability has been weak, revealing rigid decisional procedures. Coordinated policy responses have been slow. However, the crisis has given an important push to coordination of economic policies and instruments.

The unfolding of the crisis in the EZ can be explained by the interaction of institutional features and policy failures, and by their interconnection with real and financial imbalances. The aim of this paper is to analyse those factors that opened the way to the diffusion of the external shock wave in the EZ and triggered the systemic crisis of the. It also aims at discussing the structural consequences of these events and critically analyze the institutional and political reforms which the EZ is facing in order to enhance its capability to cope with external shocks.

The crisis has shown that internal divergence in the EZ is based on important structural components which are unsustainable in the long run. Indeed, the crisis has magnified the gap between the vulnerable peripheral member countries and a more resilient core. Increasingly accepted within the current debt crisis setting, the need for real convergence has never been really pursued in the EZ. Not at the national level, at which a short term national view has often outweighed more structural programmes, and not even at the European level, where the process stopped whenever there was a strong political obstacle to overcome, regardless how problematic was the stopping point. In this context, severe are the risks of tinkering with existing institutions slightly adjusted.

The next section deals with the unfolding of the crisis in the EZ, discussing the linkages among the United States and the EZ, the common weaknesses which caused synchronized shocks in the United States and in the EZ, and the idiosyncratic factors that characterize the systemic crisis of the euro. Section 3 analyses those aspects which are critical in shaping EZ vulnerability and its response to external shocks: the distinctive features of European capitalisms, the institutional architecture which leads to differential shocks in different countries and the divergent economic situation of individual countries. Section 4 discusses the dilemma confronting the EZ and concludes.

2. The Global Crisis and the EZ: External Shocks, Global Weaknesses, and Domestic Vulnerability

In the United States the crisis unfolded from a prolonged period of excess credit, the outcome of accommodating monetary and fiscal policies (Quinn Mills 2010; Razin and Rosefielde 2011). In the EZ the moving cause has been mostly external, i.e. imported from the United States through financial, real, political, and psychological linkages. The international transmission of the USA financial and economic crisis is thus often understood as a contagion process. No shared definition has yet been reached by the literature on the controversial notion of contagion, which encounters serious problems across theory and empirical work. The question which is useful to briefly recall here is the fundamental distinction, upheld by most of the literature on financial contagion (Calvo and Reinhart 1996; Kaminsky and Reinhart 2000 and Eichengreen, Rose and Wyplosz 1996), between a) the development of synchronized shocks in different countries, which are due to similar structural vulnerabilities rather than to the presence of channel of contagion and b) the cross-country transmission of shocks.[1] As to the latter, this literature further distinguishes between fundamentals-based contagion, which occurs when the infected country is linked to others via trade or finance, and true contagion which takes place when common shocks and all channels of potential interconnection are absent (Calvo and Reinhart 1996).

Many EZ banks were in fragile state when entering the sudden financial arrest (Caballero 2009) and then the Irish and Greek crises, due to easy credit and massive adoption of financial innovation, high leverage ratios, circumvention of financial regulation and high risk investments. Moreover, the house-price bubble burst wasn't the mere consequence of the US subprime mortgage crisis, but rather the burst of home grown bubbles. In the unfolding of the crisis in the EZ, the asymmetric presence of the aforementioned elements among different countries, and the interconnection of these aspects with institutional idiosyncrasies and policy failures, both at the national and at the European level, are critical. Domestic imbalances and other forms of structural and policy vulnerability (e.g. accumulated public and private debt stocks, markets rigidity, unemployment structure, demography, inequalities, fiscal policies and the differential domestic effect of the common monetary policy) have played an important role in explaining the differential vulnerability and resilience, and hence performance of distinct European countries.

From this standpoint, it is important to single out (1) the fundamental linkages among the USA and EU, which constituted the channels of transmission of external shocks to the EZ; (2) the

[1] In line with the restrictive definition of the World Bank which depicts contagion as the transmission of shocks to other countries beyond any fundamental link among the countries and beyond common shocks.

common weaknesses which fuelled synchronized shocks in the US and in the EU; (3) those idiosyncratic factors that let the Greek crisis open the way to a systemic crisis of the euro; and how those aspects interact.

Both financial and real linkages between the USA and the EU were important. The money market sudden arrest (Caballero 2009), the fact that European financial institutions held a large share of assets based on US residential mortgage and thus shared in the losses that arose once the US housing bubble burst, the sequence of falls in the stock market, all led to a substantial shrinking of bank credit. Export to the US market, which counted for 23,2% of total EU exports in 2006, started decreasing in 2007 at an annual average rate of 5,1% between 2005 and 2009 (Table 1).

Table 1: EU Trade with the USA (millions of euro; %)

Period	Imports	Variation (%, y-o-y)	Share of total EU Imports (%)	Exports	Variation (%, y-o-y)	Share of total EU Exports (%)	EU Trade Balance with the USA
2004	159,374			235,499			76,124
2005	163,511	2.6	13.9	252,683	7.3	24.0	89,172
2006	175,547	7.4	13.0	269,144	6.5	23.2	93,598
2007	181,739	3.5	12.7	261,477	-2.8	21.1	79,738
2008	186,772	2.8	11.9	250,124	-4.3	19.1	63,352
2009	159,705	-14.5	13.3	204,574	-18.2	18.7	44,869
Average annual growth (2005-2009)		-0.6			-5.1		

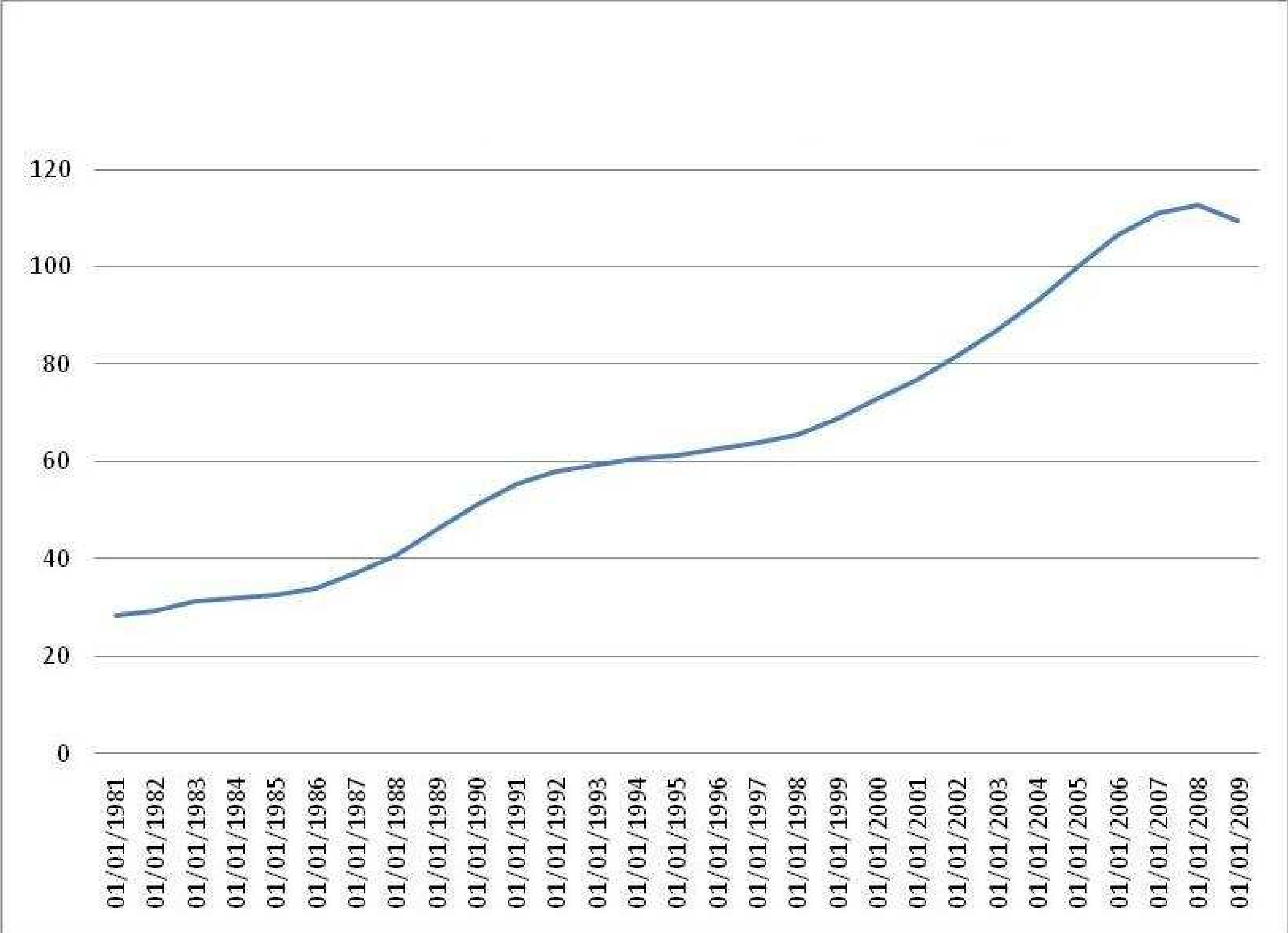
Source: Data DG Trade, 15 September 2010

The strong real appreciation of the euro before 2008 significantly hampered export. At the same time, the increasing volatility of other currencies and of the price of commodities has had an adverse impact on the European economy. The economic slowdown activated automatic stabilizers, increasing social spending and decreasing, at the same time, government's fiscal revenues.

However, as aforementioned, common excesses characterized the USA and the EU and fueled synchronized shocks: the housing bubble, massive circumvention of poor financial regulation, high financial leverage, risky financial innovation and investments in high risk assets. These factors show different trends in the different member countries, testifying of a composite scenario.

The burst of the housing price bubble (Figure 1) played an important role in the EZ crisis.

Figure 1: Residential Property Price Index, EU 16 (new and existing dwelling)



Source: European Central Bank, data 2011

In Spain, Ireland, Britain, Iceland, Estonia and Lithuania house prices had been steadily and sharply growing from the end of the 90ies to 2006,[2] as shown by the house price indices published by the Economist since 2002. The journal, in a telling article titled 'The worldwide rise in house prices is the biggest bubble in history. Prepare for the economic pain when it pops' (16 June 2005), reported that since 1997 home prices in most countries rose by much more in real terms than during any previous boom. Between 2004 and 2005 the prices of the houses grew at a rate of 9% or more in Italy, Belgium, Denmark and Sweden, reaching in Spain and France annual growth rates of over 15%, a much faster pace than those in the rest of Europe and in the USA. The growing house prices-rents ratio is a compelling evidence of the general overvaluation in the housing market. The trend was reversed in Germany, where house prices had steadily declined

[2] House-price inflation slowed significantly in 2004 in Ireland, having anyway reached impressively high levels throughout the observed period.

between 1997 and 2010 (Table 2). The Economist's measure of fair value in housing, which compares the ratio of house prices to rents in a country to its long-run average, shows a ratio in Germany well below its long-run average in the first quarter of 2010.

Table 2: The Economist House-Price Indicators (% change)

	1997-2005	Q1 2005	Q1 2010	Q4 2008	1997-2010	Under (-)/over (+) valued, Q1 2010
		on a year earlier	on a year earlier			
Britain	154	5.5	9.0	-14.9	180	31.2
Sweden	84	10.0	5.6	-2.0	159	37.0
Germany	-0.2	-1.3*	-0,4	1.1	na	-14.6
Netherlands	76	1.9	-2.0	-5.4	86	20.4
Belgium	71	9.4	-3.0	2.7	149	30.9
Italy	69	9.7	-4.1	1.1	96	13.1
France	87	15.0	-4.3	-3.0	133	39.7
Spain	145	15.5	-6.3	-3.2	166	53.4
Denmark	58	11.3	-13.1	-10.9	91	17.5
Ireland	192	6.5	-18.5	-9.7	142	24.5

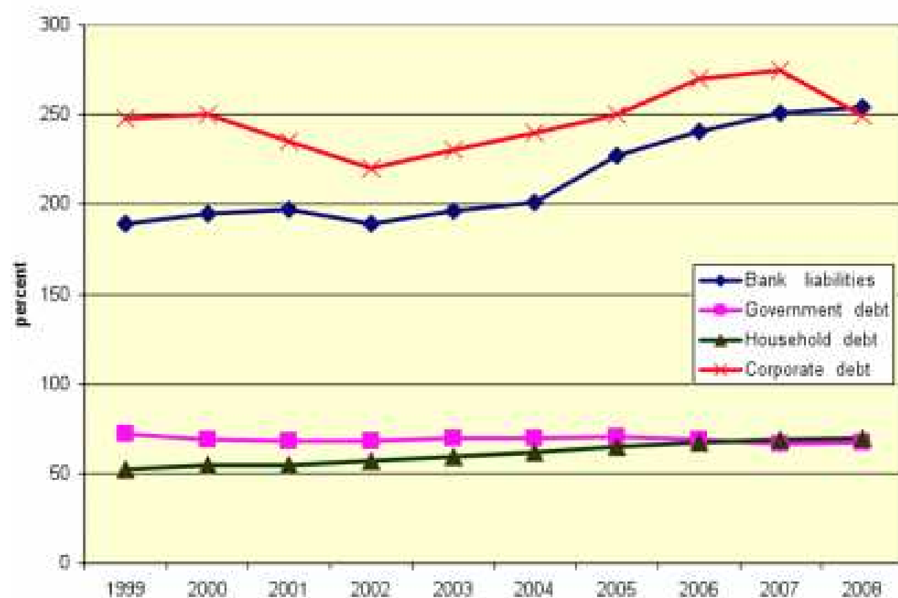
Source: Authors' compilation, Data The Economist
*average 2004

In the context of the single monetary policy and thereby of uniform interest rate policy, the uneven inflation rates which have characterized EZ member countries (Table 8) lead to different real interest rates which might have fuelled different borrowing based investments in housing among the Member States. This might have encouraged the substantial surge in private and foreign debts experienced in Eastern and Southern European countries before the crisis onset. Germany shows a different trend, with declining private debt.

As Reinhart and Rogoff (2010) empirically test on data spanning over two centuries for more than 70 countries, private debt increase, fueled by both domestic banking credit growth and external borrowing, is a recurrent antecedent to domestic banking crises, which, in turn, tend to precede or accompany sovereign debt crisis. The sequence of the events in the EZ is not an exception. What is peculiar is the unfolding of these trends within the EZ system.

In the EZ household debt increased from 52% to 70% of GDP from 1999 to 2007, while financial institutions increased their debt from less than 200% of GDP to more than 250% (De Grauwe 2010, Figure 2).

Figure 2 Private and Government Liabilities in the EZ (% GDP)



Source: De Grauwe, 2010

These aggregates cover inter-country diverging trends. Across the peripheral member countries households' debt increased at an unsustainable path, while in so-called EZ core – Germany, France, Austria, Belgium and the Netherlands – households have been fiscally more solid (Table 3).

Table 3: Households' Net Saving Rate (1995, 2000 and 2008)

	1995		2000		2008	
	Households' Net Saving Rate	Public Debt	Households' Net Saving Rate	Public Debt	Households' Net Saving Rate	Public Debt
Belgium	16.4	130.4	12.3	107.9	11.5	89.9
Denmark	0.2	72.6	-4.0	52.4	-2.4	34.2
Germany	11.0	55.6	9.2	59.7	11.2	66
Ireland		82.1		37.8	4.0	43.9
Greece	11.4	97.0	-4.5	103.4	-12.1	99.2
Spain	10.0	63.3	5.9	59.3	6.1	39.7
France	12.7	55.5	11.8	57.3	11.6	67.5
Italy	17.0	121.5	8.4	109.2	8.6	106.1
Netherlands	14.3	76.1	6.9	53.8	7.0	58.2
Austria	11.8	68.3	9.2	66.5	12.0	62.6
Portugal	6.9	61.0	3.8	50.5	-0.9	66.3
UK	6.7	51.2	0.1	41.0	-4.6	52.0

Source: AMECO; net savings as % of disposable income; public debt as % GDP

Less clear-cut a divide between core and periphery EZ countries can be identified in the financial sector, which shows in some way a reversed situation. Table 4 shows the banking exposure of Germany, France, Great Britain, Italy and Spain toward the so-called PIGS (Portugal, Ireland, Greece and Spain). Banks in the EZ core have massively invested in periphery countries. Large German current account surpluses vis-à-vis current account deficits of the PIGS, along with the latter low interest rates following the creation of the currency block, all lead to a massive interconnectedness in the EZ (Baldwin and Gros 2010). This, in turn, increased the vulnerability of the EZ banking system. This is one of the critical reasons why the refinancing crisis in Greece, which counts for less than 2% of the EZ GDP, opened the way to a systemic crisis of the euro.

Not only European banks were heavily interconnected. They were also aggressively expanding lending and overleveraged.[3] In the last decade the expansion of bank lending was massive: Irish, French, Spanish and Italian banks increased their exposition at an unprecedented pace,[4] as shown by Table 5. A default in the USA derivatives market could thus have dangerous consequences within the EU mainly through banks: strongly exposed and highly leveraged banks, which financed weak countries (both governments and private operators), when confronted with the danger of externally caused default, would put their domestic debtors under pressure. When these events set EZ weak countries in a difficult financial situation, the Euro credibility and stability could suffer consequently. This is what actually happened in 2009-2010.

Table 4: Eurozone Banking Exposure, Eurozone Core Bank's Holding of GIPS, UK and USA Debts (million of US $)

	Bank Nationality					
Exposure to	Germany	France	Great Britain	Italy	Spain	Other EZ countries
Greece	51.0	111.6	16.5	8.8	1.6	47.9
Ireland	205.8	85.7	222.4	28.6	16.2	92.5
Portugal	46.6	49.7	32.4	9.4	108	29.1
Spain	217.9	244.2	141.7	42.5		200.6

Source: Bank for International Settlements, consolidated Banking Statistics, End March 2010

[3] The high exposition of European banks toward Eastern European markets risked to erode their capital buffer, shrinking further their credit possibilities. Unicredit, Raiffeisen group, Erste Group and OTP started to report startling rises in loan losses in early August, due to the substantial amount of bad loans in foreign currencies (e.g. the Swiss franc) both to corporate and household borrowers.

[4] In Ireland total bank assets as a percentage of GDP rose from 360% in 2001 to 705% in 2007; in France from 229% to 373%, in Italy from 148% to 220% and in Spain from 177% to 280%.

Table 5: Intra-Eurozone Banking Exposure, EZ Core Banks' Holding of GIPS Debt

	1999, 4th Quarter	2009, 4th Quarter	Percentage change 1999-2009
Portugal	26	110	320
Ireland	60	348	481
Italy	259	822	217
Greece	24	141	491
Spain	94	613	554
Total	463	2033	340

Source: Bank for International Settlements, consolidated Banking Statistics, End March 2010 and Gros and Baldwin, 2010

The gap between leverage ratios (shareholder equity to total assets) and regulatory ratios was huge (Gros and Micossi 2008). The 13 largest European banks average leverage ratios was 35, versus an average of 20 in the US. The average covers big national differences, with French, German and British banks more exposed than Italian and Spanish ones, which had been subject to a more prudential domestic regulation (Table 6). Moreover, the lack of intra-EZ coordinated banking policy worsened already existing imbalances, contributing to the financial vulnerability of the largest economies (Baldwin and Gros 2010) as a result of different government responses to the problem of toxic assets. For example, French, German and Italian governments' intervention at this regard was very mild.

In this context of pre-crisis financial institutions' expansionary trend, the circumvention of regulatory requirements by European financial institutions has been substantial. Along with the massive amount of derivatives owned with the aim of alleviating regulatory capital obligations, the types of capital assets revealed structural weaknesses. It is worth mentioning the 527 billion US dollars of notional exposure of AIGFP's super senior credit swap portfolio (as December 31, 2007). Over 300 billion US dollars of credit insurance had been issued for European banks. AIG itself in the K-10 annex of the 2007 annual report defines those financial instruments as 'derivatives written for financial institutions, principally in Europe, for the purpose of providing them with regulatory capital relief rather than risk mitigation'. The immediate consequence was that AIG's crisis caused shock waves through the share prices of EU banks, as AIG's default

would have exposed the European banks' gap of regulatory capital, with dramatic effects on their ratings and on the market confidence.[5]

Table 6: European Banks' Leverage Ratio

		2007	2008	2009
HYPO REAL ESTATE HOLDING	DE	113	n.a.	78.35
DEXIA	BE	44.1	189.4	58.7
ING GROUP	NL	55.8	128.5	51
DRESDNER BANK (2)	DE	41.8	101.2	
DEUTSCHE BANK	DE	69.1	99.5	53.6
LANDESBANK-BADN-WUERTTEMBERG	DE	43	90.4	43.6
WESTLEB	DE	66.9	78.6	67.7
UBS	CH	80.7	71.8	35.3
BARCLAYS	CB	50.4	55.2	27.6
BNP PARIBAS	FR	35.4	44.6	30.4
THE ROYAL BANK OF SCOTLAND GROUP	GB	43.1	39.4	21.9
COMMERZBANK	DE	41.4	33.6	36
HSBC HOLDINGS	GB	23.8	33.5	21.8
UNICREDIT	IT	26.5	32.1	24.4
CREDIT SUISSE GROUP	CH	27.8	31	26.4
KBC GROUP	BE	23.5	30.5	41.24
BANCO BILBAO VIZCAYA ARGENTARIA	ES	24.4	28.3	22.4
INTESA SANPAOLO	IT	20.5	26.6	21.4
BANCO SANTANDER	ES	21.6	26.1	21.3

Source: Authors' calculation
(2) taken over by Commerzbank in 2009

The failure of financial and banking regulation in the EZ opened the way to the high fragility of the financial system. As Spaventa (2010) highlights, Basel II favored the undercapitalization of the banking system and contributed to the unfolding of the financial crisis through four devices: low capital coefficients; admission of hybrid capital; lax criteria for risk evaluation; and wide possibilities for circumventing the rules. A brief review of the European governments and central banks interventions in favor of the banking system (table 7) shows the massive core EZ countries' interventions towards their – highly overleveraged – institutions.

[5] As to the structure of EU banks capital, the problems raised in the summer 2010 in Germany by the decision of Commerzbank to start halting interest payments on hybrid capital in case of losses are a clear demonstration of the confusion at stake as well as of the debt rather than risk nature of this sort of participatory instruments. The 'profit-participation certificates' foresee payment of fixed interest only if the bank is profitable. This notwithstanding, Commerzbank had been paying interest on notes issued by Eurohypo even in case of losses. Moreover, as suspending interest payments was a necessary condition for receiving state bail-outs, problems arose with KBC, which considered payments on its hybrid securities mandatory, and RBS, which suspended payments only on some of its hybrids.

Table 7: Interventions (Governments and Central banks) in favor of the banking system in Europe during the current crisis (billion of euros)

Country	Capital	Guarantee	Other	Total amount	Banks involved
Austria	7.3	20.2		27.6	8
Belgium	16.2	20.0	0.2	36.4	6
Denmark	6.5	14.2	1.0	21.6	23
France	25.3		0.5	25.8	8
Germany	40.8	314.4	7.3	362.5	13
UK	85.6	704.2	2.6	792.5	16
Greece	2.8	0.5	0.1	3.4	9
Ireland	10.8	84.2		95.0	6
Iceland	0.8			0.8	3
Italy	4.1			4.1	4
Luxemburg	2.9		0.2	3.1	4
Netherlands	27.6	52.1	7.5	87.2	13
Portugal		6.2		6.2	7
Spain			9.0	9.0	1
Switzerland	43.7			43.7	1
Total	274.4	1216.0	28.3	1518.7	115

Source: ECB, European Commission, National Governments

3. Diverging Europe?

The factors discussed in the previous section need to be understood in the frame of the peculiarities of the EZ, which lead to differential impact of the crisis as well as to an uneven economic recovery within the currency block and fuelled a systemic crisis.

The following three aspects are critical in shaping EZ vulnerability and response to external shocks: a) the distinctive features of European capitalisms; b) the institutional architecture of the EZ which leads to differential shocks in different countries; and c) the divergent economic situation of individual countries, which refers particularly to the condition of public and private finance and the structure of the economy.

The distinct features of European capitalisms have been only marginally affected by the European integration which, together with globalization, has made the different systems mutually compatible through a set of shared rules and standards, but not through clearly converging institutions. The basic institutional features of the EZ can be summarized as follows:

- economic and commercial integration and flow of financial resources (freedoms and integrated markets);
- common fiscal parameters (Maastricht criteria);
- common currency (Euro);

- institutionally separated, open financial markets (with differential rules and taxation);
- unintegrated labor markets: rules in the labour market remained national – in spite of the will of European institutional architects – due to political and cultural factors and real constrains, such as the rigidity of the housing market in many countries. The EU role is basically to grant freedom of migration and equal rights of migrants.

As a matter of fact, the main differences between European forms of capitalism concern the financial systems and the labor markets, which remained national competences.

As far as the financial system is concerned, such variables as the capitalization and liquidity of stock markets and the ratio between risk and debt capital are much higher in the USA and UK than in continental European markets such as Germany, France and Italy. In the latter, banks are more important in financing firms than in the former countries, have a universal nature, and their monitoring of and control over firms is stronger (Dietl 1998; Rajan 2010), in spite of significant changes in the last two decades. In such a way they are often able to detect early risky situations in firms and push them to rescue, thus avoiding default. Although capital re-allocation is slowed down, the rapid contagion by financial crises can also be hindered. In this kind of economic system, though, the risk of private gain from control, entrenched management, and side dealings between banks and firms may be a relatively serious problem and may slow down post-crisis recovery.[6] As a matter of fact, European progress towards truly unified financial markets and taxation has been bumpy to say the least: the most important European instrument so far has been periodical cross-controls by national authorities with some support by the European Union on so-called fiscal paradises within the Union and the control that taxpayers pay taxes in the country where they reside.

As to the labor markets, entry and exit flexibility are usually higher in such countries as the USA, UK, and Ireland, and seniority relations and firm specific investments are more important in continental Europe. Due to these features, European labor markets are usually less reactive to financial shocks, thus hindering the contagion of the real economy, although at the price of slower labor re-allocation, youth and long-term structural unemployment.

The institutional architecture of the EZ is intended to create opportunities for European countries and increase systemic resilience through an enlarged market and greater financial

[6] According to Joseph Lutton at JP Morgan (quoted in Rajan 2010, p. 238), 'the U.S. Federal Reserve started raising rates 20 months after peak unemployment in the 1990-91 recession and 12 months after peak unemployment in the 2001 recession. By contrast, the euro area not only cut rates less but also was quicker to rise rates, doing so 7 months after peak unemployment on average in the 1991 recession and 9 months after peak unemployment in the 2001 recession.'

discipline. However, it also introduced new elements of vulnerability, in particular through the decoupling between fiscal and monetary policies and the asymmetry of mobility and flexibility between financial and labour markets. The common currency exacerbated both outcomes.

The institutional asymmetry has to be seen in conjunction with the inherited and new structural imbalances, i.e. the imbalances which derive from the economic history of the member countries, in particular productivity differentials and the relation between public and private finance. Given the institutional architecture, these imbalances have prepared the scene for problematic and asymmetric adaptation to the global crisis.

To work properly as it was designed the EZ should have complied with a number of requirements. Among the most important are: a) European integration and globalization should have been compatible: this aim was largely implemented; b) a common monetary policy should have accompanied monetary integration: a goal that was implemented successfully, the ECB having kept inflation around 2%; c) common criteria for fiscal policies should have been identified and enforced upon member countries: the Stabilization and Growth Pact (SGP) has been repeatedly broken by some of its members, even though the EZ16 as a whole exceeded the limit of 3% target only once; d) resources should have flown from strong to weak countries for supporting microeconomic convergence: this was a major failure of the integration process, also because the EU concentrated on macroeconomic issues; and e) domestic microeconomic adaptation and transformation should have been pursued with the support of national governments: another major failure. Overall, and in spite of important successes, the integration process was asymmetric to the disadvantage of the microeconomic side as compared to the macroeconomic one, thus generating an unbalanced integration. This asymmetry is the most critical element of EZ vulnerability, particularly in the long run.

There is an interrelation among the above successes and failures that contributes to explain the external and internal vulnerability of the EZ in front of the international crisis. The monetary integration has strengthened the European monetary system, limiting the aggregate vulnerability to exogenous shocks of Member States. Smaller states with limited capacity to manage their currency could rely on the credibility of the Euro and the common monetary policy, while financially weaker economies gained reputation by giving discipline and credibility to their budgets anchored to European shared rules. The monetary integration and the introduction of a common currency thus led to enlargement of markets, easier and smother internal flow of resources, elimination of exchange rate risk and uncertainty, and reduction of transaction costs. Since monetary integration increased the domestic effect of asymmetric shocks, due to the lack of the monetary lever, national sovereignty of fiscal policy was conceived as the main institutional

device for national adaptation along with EU budget transfers. The entire system was conceived to strengthen national and European resilience to external shocks.

This process of integration and the EZ creation, together with globalization, exposed productivity differentials and made their sustainability hard, at least in the long run. Indeed, traditional coping mechanisms (in particular, the depreciation of the national currency) disappeared. In order to overcome these differentials, policy-makers promoted pro-market policies in favour of profits since the Seventies, thus causing growing distributive disparities which obtained additional peculiar drivers within the EZ. They were intended to provide incentives to investment for fostering productivity convergence. Growing employment and income should have resulted through trickle-down mechanisms, thus boosting demand and production.

However, this standpoint disregarded important effects, thus meeting with unforeseen events. Indeed, increasing inequalities have reduced the importance of domestic markets, particularly of domestically produced commodities consumed by the middle-income population and have hampered opportunities for people in general and potential entrepreneurs in particular (e.g. through the polarization of savings that dried up an important source of diffused, small-scale investment). This resulted in segmentation of the economy, the society, and finally the EZ. This outcome had particularly disadvantageous effects in laggard countries. Segmentation within countries in turn depressed demand, production, and savings and fostered public and private debt. Since segmentation was primarily to the disadvantage of the middle class, a politically and economically sensitive domain, policies tried to foster the trickle-down mechanisms by supporting the middle-class consumption through different channels (easy credit, particularly for consumers and housing) Such policies increased the countries' and economies' vulnerability. Vulnerability, together with non-convergent fiscal rules at the European level, created the conditions for microeconomic failures hampering macroeconomic convergence and stability.

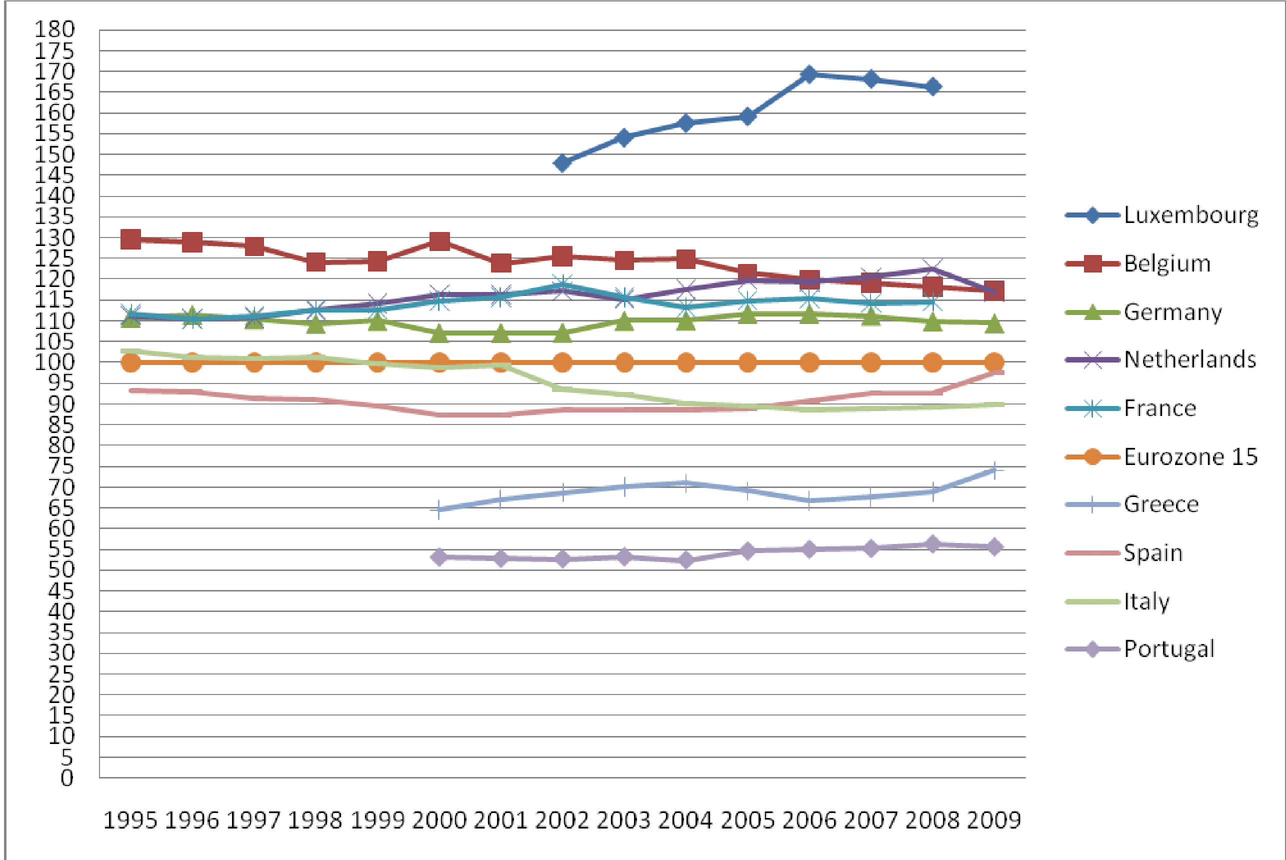
In this frame the crisis has indeed magnified the gap between the vulnerable peripheral EZ member countries and a more resilient core, made up of economies with high private savings, low public debt and strong current account surplus, low disparities, high productivity and low unemployment. These economies, whose prototype is Germany, are competitive internationally and internally and capable of affording microeconomic reforms which further increase their competitiveness. They can thus implement and sustain financial constraints. On the other hand, EZ periphery is undergoing a remarkably severe downturn, which is urgently calling at the time of writing for resolute intervention spanning from 'internal devaluation', mainly through wage

adjustments (Baldwin and Gros 2010), to credible fiscal action and structural reforms (Draghi 2010), to sovereign default (Rodrik 2010) and debt restructuring (Eichengreen 2011).

At a general level of analysis, peripheral economies suffer from low or negative savings, low productivity (Figure 3) and activity rates (mostly to the disadvantage of women), high disparities (Figure 4) and unemployment (with remarkably elevated youth unemployment), rapidly rising ratios of debt to gross domestic product, high fiscal and current account deficits and elevated interest rates. The specifics differ among Greece, which meets all the aforementioned features, Portugal, which has low public and high private debt, Spain, which has low savings and low public debt, Ireland, experiencing a bank and financial system crisis hampering financial stability, and Italy, which has elevated private savings but suffers from high public debt (Table 8).

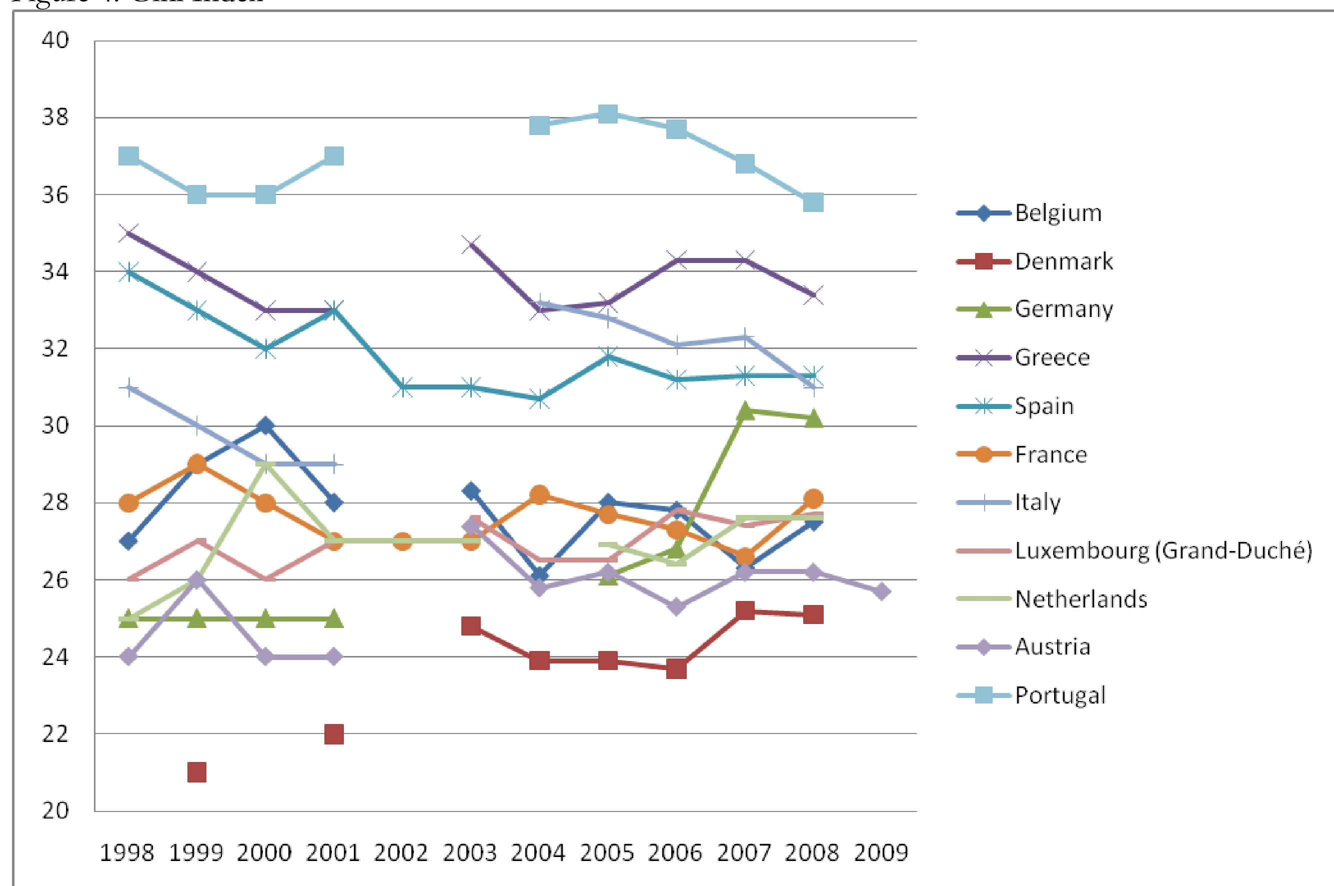
All of them have been unable to comply with structural and microeconomic reforms and to implement and sustain financial constraints, and are consequently uncompetitive both externally and internally.

Figure 3: Labor Productivity per Hour Worked (EU-15 = 100)



Source: Eurostat

Figure 4: Gini Index



Source: AMECO

Table 8: Deficit, Current Account, Inflation and Growth in the EZ: 2000-2007

	Cumulative deficit, % GDP	Cumulative Current account, % GDP	Cumulative Inflation above EZ16 rate, percentage points	Cumulative growth above EZ average, percentage points
Austria	11.8	13	-4.1	1.014
Belgium	2.7	26	-1.0	0.002
Finland	-32.4	50	-5.3	10.5
France	21.7	4	-3.3	-0.3
Germany	17.7	26	-4.2	-5.3
Greece	40.0	-67	8.1	16.6
Ireland	-11.9	-15	10.0	31.0
Italy	22.9	-10	1.0	-5.5
Luxembourg	-18.6	83	4.1	21.2
Netherlands	4.7	45	2.4	0.2
Portugal	28.9	-71	6.3	-5.6
Spain	-2.3	-46	7.6	11.7

Source: Baldwin and Gros, 2010

When the Euro has been introduced in 1999 (2001 in Greece), member countries differed remarkably in fundamentals as well as in the structure and the dynamism of the economy. The working of the EZ has reinforced previous patterns, amplifying divergences rather than easing structural convergence. The common currency and monetary policy prevented unbalances to be solved through currency depreciation. At the same time, common fiscal parameters to be complied with limited significantly the members' freedom to set fiscal policies. Indeed, in an integrated area with common currency only microeconomic reforms are possible and effective to improve the performance and competitiveness of individual economies. In particular, economic adjustments were meant to be obtained *via* labour market reform aimed at increasing flexibility and lowering real wages.

In this context, the idea behind free circulation of capital – the risk of countries default being equalized thanks to the EU guarantee – is that capital should flow from strong countries to weak countries, where interest rates are higher (positive spread). The flow of capital to weak countries should re-establish equilibrium and even out interest rates. To this end the EU has established the Maastricht criteria to avoid governments' free-ridings in public finance.[7] These criteria include a set of controls and also the possibility of punishment for non-complying countries.

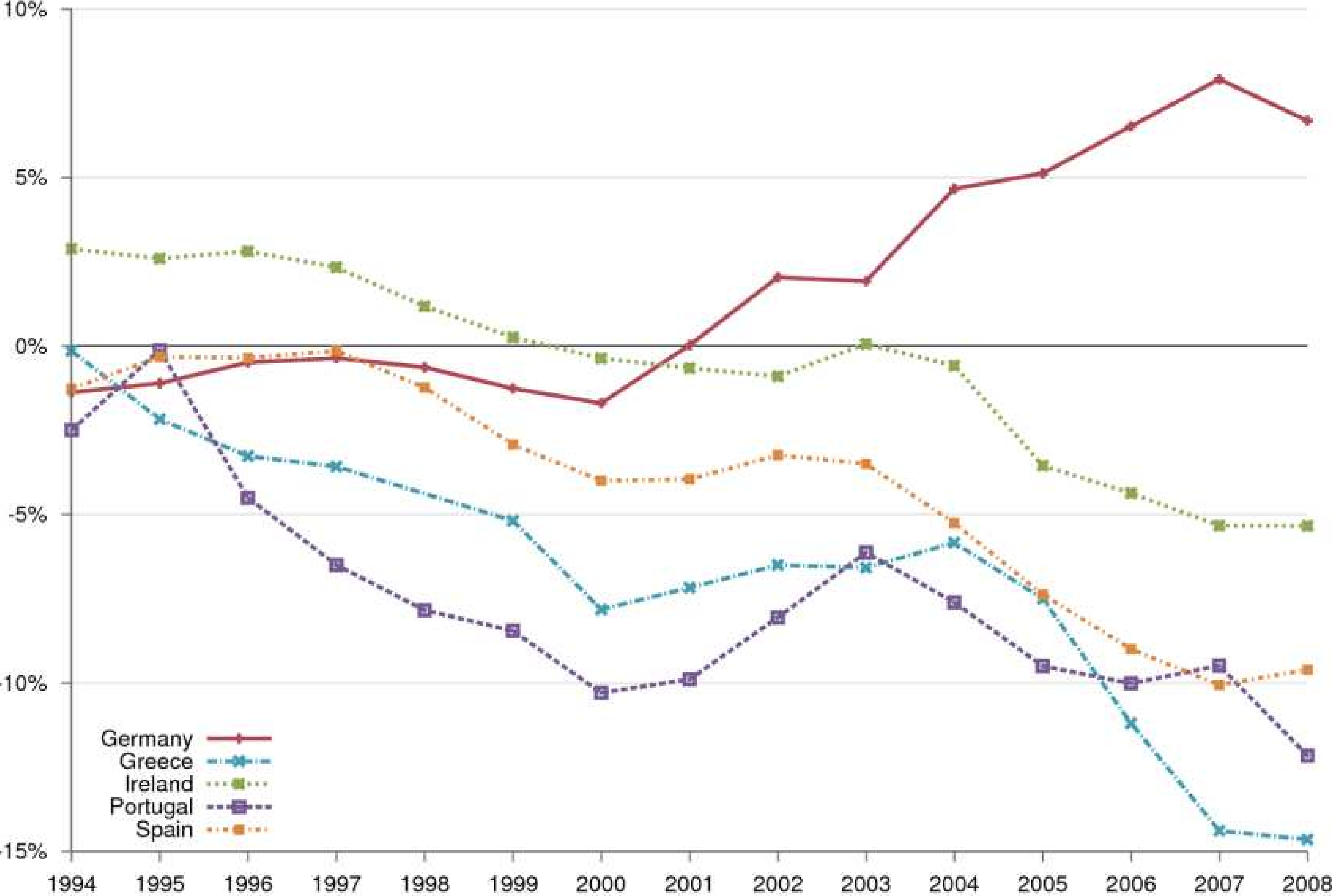
As aforementioned, however, the equilibrating mechanisms foreseen in the EU build-up did not work properly (in particular because of the lack of control over fiscal policies to balance asymmetric shocks and the failure of microeconomic reforms). Yet, it turned to be to the advantage of strong countries, in particular Germany, and to the disadvantage of weak countries.

Weak countries suffered higher price increases which had effects similar to real exchange rate appreciation and led to export discouragement. If labour market reforms had worked as expected, compression of wages could have counterbalanced this effect. However, this kind of reforms encounter two serious problems which make them easier to be pursued and more successful in stronger economies as Germany than in EZ peripheral member countries. These problems are related to the structure of the economy and of the welfare state provisions. First, the scope of these reforms is narrower in the periphery, where real wages are lower and social services are worst. Compression of wages would exacerbate the negative consequences of increasing inequalities and jeopardize labour incentives and productivity. Second, the consequences of focusing on downward wage flexibility rather than on investment in infrastructure, research, innovation and human capital in rather static economies with low level of technology are, in the long run, serious for competitiveness pushing them to choose labour

[7] Compared to a fixed exchange rate system, the common currency area has to solve the critical and potentially dangerous problem of avoiding free-riding among member countries to the disadvantage of virtuous ones.

intensive and low productivity technologies. Relative costs in the periphery have thus risen for a decade, leading to loss of competitiveness in the rather closed EZ real economy where the bulk of trade takes place among member countries (Table 9). This situation favored strong countries, particularly German producers: their traditional competitors could not take advantage by depreciating their currency. Moreover, the euro has been much more conducive to additional EZ exports than a strong Deutsche mark would have been. Strong countries accumulated increasing current account surpluses with weaker member countries (Figure 5).

Figure 5: Current Account Balance (% GDP)



Source: IMF BOF, in Lapavitsas et al. (2010)

They kept balance of payment equilibrium by exporting capital to weak countries where returns were higher, although riskier. The high growth rate in Ireland and Spain has been fuelled by this inflow of capital, which, however, went mainly into non tradable activities as construction. The gains of the periphery were, as Wolf puts it, transitory, if not illusory (Wolf, 2010). Strong countries' advantage came at the cost of the weak countries' inability to comply with common fiscal rules, thus increasing systemic risk that, in turn, hit particularly the credibility of strong countries. If the EZ economy proved to be rather stable in the short run, it nevertheless

progressively accumulated tensions. At the basis there was the inability to implement microeconomic reforms.

Table 9: Intra EZ Export (% of total export)

	2005	2008
Belgium	76.4	77.0
Czech Rep.	84.2	99.4
Denmark	70.5	69.9
Germany	63.4	63.7
Ireland	63.4	68.3
Greece	52.9	64.0
Spain	71.8	68.2
France	62.6	63.0
Italy	58.6	58.5
Luxemburg	89.4	89.0
Netherlands	79.2	78.7
Austria	69.3	72.3
Portugal	79.8	73.7
Finland	56.0	55.9
Slovenia	66.4	68.1
UK	56.9	56.9

Source: EUROSTAT

4. European Sovereign Debt and Euro Crises: the Fork in the Road of the EZ and the Risks of Muddling Through

In *A Euro Rescue Plan*, a public appeal to the German Federal Government, Franz, Fuest, Hellwig and Sinn, four leading German economists directly committed in policy advisory at the Federal level, stated that 'What Europe needs is not an economic government but political and economic mechanisms that effectively limit public and private indebtedness in the member states'. In their interpretation the EZ crisis is ascribable 'to the debt and financing problems of some euro

member states' (Franz, Fuest, Hellwig and Sinn, 2010, p. 101), and the crisis of the euro was a 'danger to very specific countries rather than a systemic danger of the euro system as such' (Sinn, 2010, p.7).[8] They moreover identify 10 fiscal-policy rules for strengthening national individual responsibility, defined in the document as a *conditio sine qua non* for the survival of the European Monetary Union. It is worth recalling rules 9 and 10 here: a majority of the EZ members may ask an insolvent country to leave the EZ, and a voluntary exit from the EZ must be possible at any time.

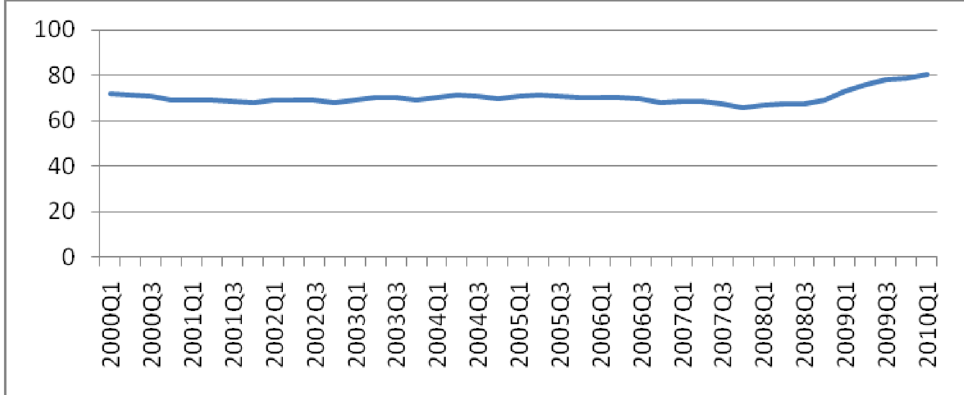
The main points of this analysis are the following: the EZ has always been suffering from economic imbalances which burdened its development. In particular, the irresponsible fiscal policies of peripheral countries led to unsustainable level of public – and private – debts and fiscal deficit and had pernicious economic spillovers to virtuous countries. Irresponsible policies overheated these economies, leading to a huge flow of investments towards these countries which inflated bubbles whose bursting hampered EZ sustainability. While the EU was ineffective in imposing the respect of the rules designed for avoiding negative spillovers, fiscal stabilization is now deemed as badly needed.

The Authors' position epitomizes a widespread vision of the dynamics underlying the crisis in the EZ. The unprecedented depth and magnitude of the crisis has put the sustainability of the EZ institutional and political framework into question. If the urgency of a comprehensive reform is widely acknowledged, the direction that this reform should take is question of debate. The necessity of a clear leap forward toward integration is recognized in part of the academic debate. Far less clear on this issue are even those policy makers most committed with the European project. On the other side, the focus on national interests has sensibly risen since the onset of the Greek refinancing crisis. The bulk of European policy makers appear more concerned with the reaction of their domestic constituencies than with a EZ coordinated strategy. The discussion is shifting towards the evaluation of how costs are allocated and gains are distributed among members in a sort of zero-sum-game logic. The public debt crisis in the periphery of EZ, the ECB securities market programme, the bail out of Greece worth 110 billion euros and the Special Purpose Vehicle worth 750 billion euros, the bail out of Ireland worth 85 billion euros, all gave rise to a harsh political and scientific debate on the working of the EZ and the reform of its institutions, giving fuel to what has been labeled as a new German question.

[8] The starting point of their analysis of the EZ crisis is the integration of capital markets which followed the EMU and led to a convergence of interest rates in the EZ, regardless the underlying different country risks. This, in turn, caused a massive capital flow toward the southwest periphery of Europe. The consequences were threefold: a boom in construction and investments in these countries, which ended up in bubbles whose busting is now threatening solvency of banks and public finance; the unsustainable level of government deficit.

In a context of shrinking budgetary revenues, of fiscal consolidation and of common monetary policy, deflation – in particular the cut of wages, pensions and other costs – is addressed as the unique, and necessary, adjustment mechanism for deficit countries. There is widespread agreement, as well, in identifying differentials in downward rigidity of labour cost as the critical determinant of inflation and competitiveness differentials among member states. Therefore, the pillars of post-crisis recovery are identified as fiscal austerity, wage flexibility and regulation. If the scientific and policy debate over fiscal austerity is getting more and more momentum in USA and Europe,[9] far less momentum seems to have gained in Europe the question of real convergence. Yet, two of the more risky countries, Ireland and Spain, have been remarkably disciplined in containing their debt. Much more than countries as Germany and France, which broke the Stability and Growth Pact respectively four and three times from 2000 to 2007. The problems do not lie in the fiscal behavior of a group of peripheral members, but rather in the different starting conditions of the members. Greece is the only peripheral country which was fiscally irresponsible, hiding the actual amount of her public debt and deficit. The sovereign debt crises of the others is mainly the effect of the public rescue of the financial sector (Figures 6 and 7). Governments and central banks interventions in terms of capital and guarantees towards the financial sector absorbed respectively the 13% and the 30% of EU GDP as to December 2009. This happened in a context of high pressure on public finance due to the working of automatic stabilizers.

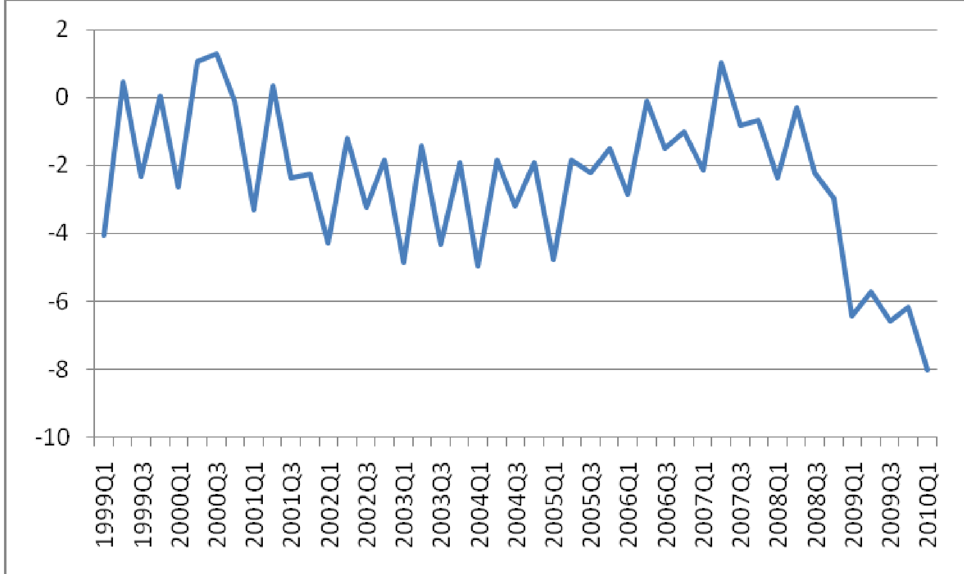
Figure 6: Average government debt as a percentage of GDP in the Eurozone



Source: OECD

[9] Testified by the extreme position of the so-called generational accountants, a strand of research developed since the early 90ies, for example, by Kotlikoff of the Boston University. In this line was the article by Hagist of the Freiburg University on Britain fiscal position published by the Financial Times in July 2010. Fiercely faulted by Galbraith, who defined them 'not only wrongheaded, but also dangerous' as well as inconsistent in their analysis, generational accountants calculate fiscal gap as the difference between the amount the government will be able to collect by present and future generations, and the amount it is expected to spend. The figures are therefore much higher than those calculated through standard measures.

Figure 7: Average government deficit as a percentage of GDP in the Eurozone



Source: OECD, data neither seasonally nor working days adjusted

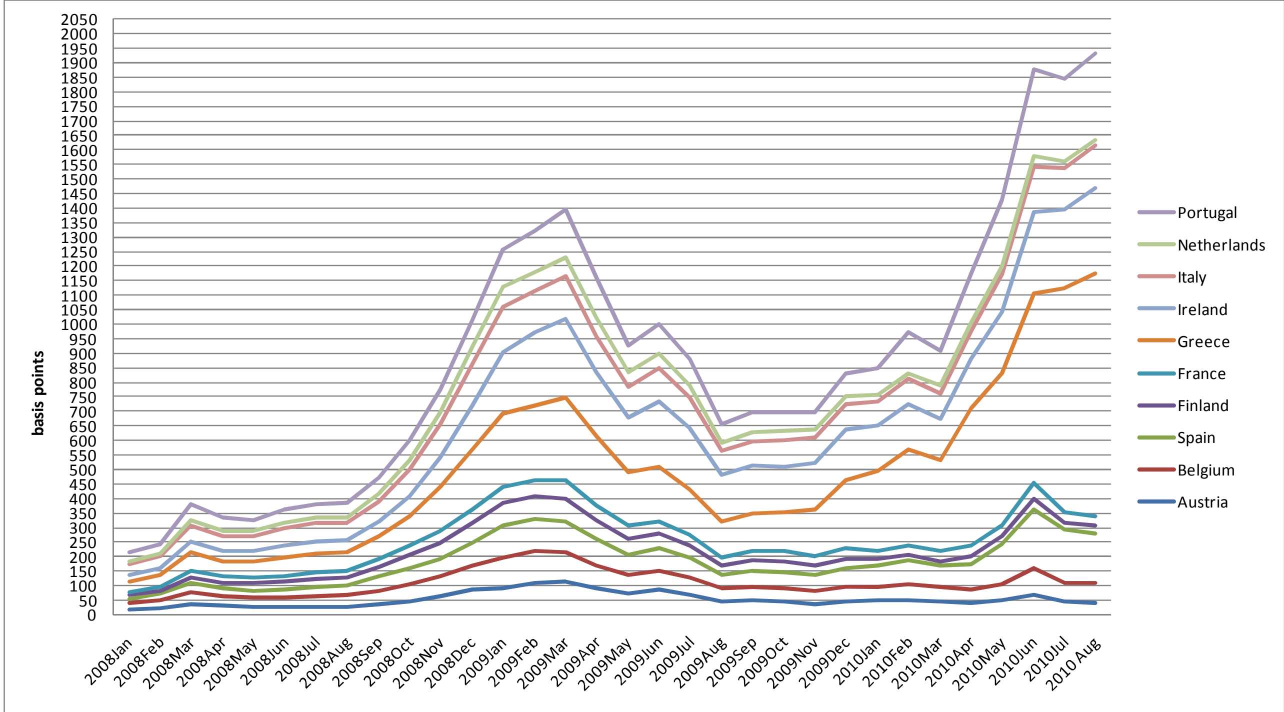
This notwithstanding, if ECB engaged since 2008 in massive liquidity provision in order to allow overleveraged European banks to adjust their balance sheets, the support to member countries suffering speculative attacks on public debt has been slow, encountering fierce opposition by Germany. This poses a weighty responsibility to the EZ decision makers, especially in consideration of the credit crunch under which peripheral members were seeking extra funds in the financial markets. The collapsing of lending put upward pressure on yields. Irish, Greek, Portuguese and Italian bond yield spreads vis-à-vis the German bond rose to unprecedented high levels (Figure 8). Moreover, as Krugman highlights, a likely reason of the loss of lenders' confidence has been the very existence of the euro, which implies that troubled countries 'have to deflate their way back to competitiveness, with all the pain that implies' (Krugman, 2011).

Moreover, only two years after Lehman Brothers' default European institutions have started the reform of financial regulation.[10] However, the deadlines set, and the lack of any provision for the shadow bank system, will leave the financial system highly exposed for long, allowing capital migration towards countries with milder regulation and thus hampering efforts of more rigorous countries. If the USA asks for more rigorous regulations than Europe, Germany maintains the necessity of a longer timeframe in order to sustain her public banks which needed the second

[10] The roadmap is made up of four pillars: 1. Capital ratios, defined within Basel III in September 2010 and analysed in the subsequent G20 in Seul, which anyway are to be implemented since 2013-2014 and to be fully accomplished by 2019; 2. regulation over derivatives, CDS and short sells, presented on the 15 September, which will have to be discussed and approved by European and national Parliaments and be into force by 2012; 3. The institutions too big to fail; and 4. The shadow bank system. Moreover, minimum standards of leverage ratios and of short term liquidity will be defined respectively in 2018 and 2015.

biggest public rescue plan (both in terms of capital and of guarantee) in Europe after UK.[11] A substantial leap forward in financial market supervision has been made with the establishment of European Systemic Risk Board (ESRB),[12] an independent body responsible for the surveillance of the financial system within the Union, and of the three European supervisory authorities (EBA, EIOPA and ESMA) which are to ensure an improved prudential supervision of banks, insurances and investment firms.[13] These innovations add room for coordination to the still very nationally-oriented financial supervision. However, banking and finance regulation could have been dealt with in stricter connection with the reform of the economic governance, being the vulnerability of sovereigns unavoidably related with that of banks.

Figure 8. Interest rates spread in Europe



Source: OECD

As to the economic governance, the European Council endorsed on October 2010 the Report of the Task Force chaired by Van Rompuy, established to devise proposals for better budgetary discipline and an improved crisis resolution framework (European Council, 2010). Even though the Council and the European Parliament intend to reach agreement on the Commission's

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[11] The German banking association foresees that, following Basel III standards, the 10 biggest banks could need 105 billion euros of recapitalization.

[12] Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24/11/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.

[13] The European System of Financial Supervision (ESFS) comprises – along with the ESRB, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) – the Joint Committee of the European Supervisory Authorities (ESAs) and competent authorities in the member states.

legislative proposals only by Summer 2011,[14] it is nevertheless useful to briefly recall here the main features tabled so far.

The Report focuses on five domains: greater fiscal discipline, new economic surveillance mechanism, enhanced coordination, robust framework for crisis management and stronger institutions for more effective economic governance (Task Force, 2010).

The main focus remains fiscal discipline further enhanced, with broader criteria for the assessment of public finance stability and a wider range of sanctions and measures of financial,[15] reputational and political nature in both the preventive and corrective phases of surveillance (Task Force, 2010).[16] A greater importance is given to public debt and to the interplay between the latter and deficit. Debt surveillance is threefold: a) all countries which don't meet the target – 60% of GDP – need to reduce the debt every year at a rate of one twentieth of the excess part; b) in the frame of the preventive phase, member countries which exceed the target of public debt are to define and implement medium-term budget objectives even if the deficit target is met; and c) the level and the dynamic of the debt will play a substantial role in the deficit infringement procedures. A reverse majority rule for the adoption of enforcement measures is proposed, in order to limit bargaining processes and make the operation of the GSP more 'technical'. Moreover, with the aim of strengthening institutions, public bodies providing independent analysis, assessments and forecasts on domestic fiscal policy matters are recommended. The coordination among member countries is enforced through the European Semester, started on January 2011 with the aim of simultaneous assessment of both budgetary measures and structural reforms fostering growth and employment (Task Force, 2010).

The provision of a permanent crisis management, the European Stability Mechanism (ESM), has been foreseen by the Report, agreed by the Euro Area Ministers of Finance in November 2010 and endorsed by the European Council in December 2010. ESM will be operational as of mid-2013 following the expiry of the existing European Financial Stability Fund (EFSF) and the European Financial Stability Mechanism (EFSM), with the aim of supporting countries in financial distress. Private sector involvement will be decided on a case-by-case basis, in line with the IMF practice.

The need for broadening macroeconomic convergence beyond the budget focus of SGP has been recognized through the provision of vulnerability indicators to be monitored. A first

[14] COM (2010) 522; COM (2010) 523; COM (2010) 524; COM (2010) 525; COM (2010) 526; COM (2010) 527; all adopted on 29 September 2010.

[15] These are interest-bearing deposits and fines.

[16] These are enhanced reporting requirements, ad-hoc reporting to the European Council and enhanced surveillance, eventually followed by a public report.

assessment of a scoreboard made up of indicators as private debt, competitiveness, current account, credit expansion, level of prices, and productivity growth would be followed by in-depth analysis in case of actual or potential excessive imbalances. However, recent literature has questioned the use of scoreboards (Manasse and Roubini, 2009) and pointed out that some of the areas specified should be addressed by European regulation and supervision (Manasse, 2010; Spaventa, 2010). The Report foresees that 'in particularly serious cases, an 'excessive imbalance position' should be launched by the Council, with a deadline to take a set of policy measures to address the problem. Euro area Member States may ultimately face sanctions in case of repeated non-compliance' (Task Force, 2010, p.2). The infringement procedure appears unlikely to be put into practice for a number of reasons, the time lag which reforms encounters to produce effects, the difficulty of establishing targets in these areas, and the lack of competences of the Commission in a substantial number of areas being the most relevant.

To date the institutional framework of the EZ has been focused on monetary integration and common fiscal parameters, leaving to loosely coordinated national initiatives banking and finance regulation as well as structural reforms. The latter were however recognized important for the smooth working of common monetary policy and should have been harmonized via the Lisbon Strategy. Competitiveness policies and current account imbalances were instead completely left to the national level. The enhancement of labour flexibility and the adjustment of nominal and real wages in order to help absorbing shocks – as long as the increase of retirement age, the decrease of average and marginal tax rates and of unemployment benefits – have been for long considered the only way ahead (Trichet, 2007) for fostering productivity and labour utilization while maintaining stable macroeconomic conditions. The pressure of the EZ at this regard has been high, exerting a deep influence on national attitudes towards labour policy. Yet, this influence has been much wider than the actual European competences would suggest. On the other side, the commitment of the EZ towards social protection has been poor to say the least.[17] Notwithstanding intense debate on growth and convergence, this structuring doesn't seem to be substantially changed in the reform proposals so far.

France and Germany are upholding a pact of economic convergence to strengthen the competitiveness of European economies. This pact, which is a highly disputed issue at the time

[17] For example, the management of the flagship European Globalisation Adjustment Fund has been since its creation in 2007 unsatisfactory, leading to an embarrassing actual esbursement of euros 140m out of nearly €2bn available (just over 5 per cent of total capacity) due to sclerotic bureaucratic procedures, as highligted by Pignal (2010).

of writing, foresees the removal of automatic indexation of wages to prices, the delay of the age of retirement according to demographic developments, the leveling of taxation, development instead of binding caps deficit, mutual recognition of diplomas and professional qualifications, a common corporate tax base, national crisis management regime for banks, debt-alert mechanisms into their constitutions and the provision of infringement procedures. The bulk of these proposal magnify rather than mitigate pro-cyclical adjustments and are tailored according to a 'German model' of development. As Manasse reminds, fiscal policy should be mildly counter-cyclical in order to minimise tax distortions over time and maximise welfare, while the 'tougher budget cuts, the deeper the recession' (Manasse, 2010). As aforementioned, moreover, high pressure on downward flexibility in the labour market as the only way ahead for growth and competitiveness encounters risks of increased segmentation and negative effects on the quality of the human capital, along with deterioration of standards of living and social unrest. Strong is the need of tackling the real roots of high productivity differentials among member states, and not only fiscal consolidation. Not only is convergence of productivity essential for the stabilization of the euro in the long run, it is also a necessary condition for the sustainability of a European institutional framework.

The EZ is a highly interconnected monetary union in which the links between members are both real and financial. Fiscal policies in each of the countries have systemic implications. Therefore, both surplus and deficit countries, to recall Eichengreen (2010), 'have the responsibility for contributing for its stability and smooth operation'. Yet, the Monetary Union, being an extreme case of fixed exchange rate schemes, relies only on deficit countries for addressing trade imbalances, thus showing a bias toward deflation. If deficit countries are expected to cut prices and wages to curtail trade imbalances, surplus countries are not required to countervail them by boosting internal spending. It is the very rationality of EZ institutional setting (institutional and policy 'dualism'), together with diverging interests and the national governments' myopia, which is at the heart – together with the weakness of the European Commission - of the lack of a concerted European fiscal response to asymmetric shocks, and namely to the current crisis. This fact, being the EU a productively integrated area, hampers the effectiveness of national fiscal strategies, and weakens the resilience of the Member states in coping with the global financial crisis and depression. It also undermines the influence exerted by the EU response at the monetary level.

It seems that the EU has to return urgently to the old spirit of a positive sum game in a radically new context which has now jeopardized mutual trust. What EZ needs are institutional reforms

and policies based on the acknowledgement of the Member State's interdependence, and coordinated adjustments towards higher balance among members. In this perspective, critically important is a new credible pact whereby strong member countries finance growth in weak countries in exchange for fair returns and the right of inspection of correct financial management through European authorities. This would require, on the one side, to pursue the long-term aims of tackling productivity differentials, supporting investments in infrastructure and intangible assets, savings and a more balanced pattern of consumption, thus decreasing disparities. On the other side, this would entail less formal and static fiscal criteria, which could foster long term investments and punish acritical public spending.

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