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Euro Zone Crisis and EU Governance: Tackling a Flawed Design and Inadequate Policy Arrangements

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Abstract

This paper focuses on roots of strain in the European Monetary Union (EMU). It argues that there is need for a thorough reform of the governance structure of the Union in conjunction with radical changes in the regulation and supervision of financial markets. Financial intermediation has gone astray in recent decades and entailed a big bubble in the industrialized world. Waves of financial deregulation have enhanced systemic risks, via speculative behavior and growing inter-connectedness. Moreover, the EMU was sub-optimal from its debut and competitiveness gaps did not diminish against the backdrop of its inadequate policy and institutional design. The euro zone crisis is not related to fiscal negligence only; over-borrowing by the private sector and poor lending by banks, as well as a one-sided monetary policy, also explain this debacle. The EMU needs to complement its common monetary policy with solid fiscal/budget underpinnings. Fiscal rules and sanctions are necessary, but not sufficient. A common treasury (a federal budget) is needed in order to help the EMU absorb shocks and forestall confidence crises. A joint system of regulation and supervision of financial markets should operate. Emergency measures have to be comprehensive and acknowledge the necessity of a *lender of last resort*; they have to combat vicious circles. Structural reforms and EMU level policies are needed to enhance competitiveness in various countries and foster convergence. The EU has to work closely with the US and other G20 members in order to achieve a less unstable global financial system.

Introduction[1]

The sovereign debt crisis has created enormous anguish in the European Monetary Union (EMU) and emergency measures are used in order to prevent its breakdown. The European Council summit of October 2010 considered a Task Force report with a telling name: "Strengthening economic governance in the EU". This document is to be examined in conjunction with the governance reform proposals issued by the European Commission and related documents. In March 2011,the Council adopted the Euro Pact and the European Parliament approved the 6 pack reform in the second half of 2011. But this demarche is not an attempt to explore a terra incognita. From the very beginning of the EMU there was some discomfort with its institutional underpinnings and there were misgivings regarding its optimality as a currency area. This explains why a train of thought underlines a political rationale, too, for its creation. Likewise, criticism over the way regulation and supervision were established in the Union is not of recent vintage. And insufficiencies of the Stability and Growth Pact (SGP), with almost all member states flouting its rules at various points in time, were repeatedly pointed out. This said, however, the flaws of financial intermediation have been less considered by policy-makers and central bankers for reasons which, partially, are to be found in a paradigm which has dominated economic thinking in recent decades. This paper focuses on roots of the huge strain in the Union and policy issues ensuing from the current crisis. Nota Bene: there is a "political reality" which constrains decisions in the EMU; the latter is not a federal structure and what appears to be rational when defined strictly economically may clash with implications of the political configuration of the Union.

1. Roots of strain in the EU

1.1 A Financial System Gone Astray

Financial stability has staged a formidable comeback on the policy-making agenda in advanced economies. The current crisis has exposed flaws in the working of financial markets; this crisis cannot be explained only by years of cheap money and growing

[1] The paper prepared for the CASE conference 'The Future of European Integration", Warsaw 18-19 November, 2011; it relies on Daianu (2010) and Daianu&Lungu (2011)

imbalances in the world economy. Mistakes in macro-economic policy were accompanied by gross abuses of securitization, excessive leverage, abnormally skewed incentives and a loss of *moral compass*, inadequate risk-assessment models and failures to check for systemic risks, a breakdown of due diligence and an almost blind belief in the self-regulating virtues of markets.

Structure is key in understanding the current crisis. On the one hand, it can derail even brilliantly conceived policies; on the other hand, it can shape policies wrongly. For instance, complacency vis-à-vis the expansion of financial entities overexposes economy to major risks (like it happened with Iceland,Ireland, UK, etc). Or take a premature opening of the capital account, as it occurred in numerous emerging economies, and the paradigm and policy approach which propounded total deregulation of financial markets as a means to foster economic growth.

Financial intermediation, as it has evolved during the past decades proves that not all financial innovations are good, that inadequate risk and business models have been used by banks and other financial institutions. Quite a while ago warnings were sent regarding the growing opaqueness of markets due to securitization and off balance sheet activity. Lamfalussy (2000, p.73) noted that financial integration made "crisis prevention and handling it more difficult"; unregulated financial markets have turned into an *in-built destabilizer*.. Moreover, the financial industry has become oversized in not a few economies.

The paradigm shift which is, currently, underway is rediscovering systemic risks: the complexity and inter-connectedness of financial markets, contagion effects, "Minsky moments"[2]. But there is need to make here a distinction between two opposed cognitive approaches: one that believes that nothing can be done about the evolution of markets, whatever the way financial innovation goes; and another approach, which does not take the complexion of markets as God given and has misgivings about a range of financial innovations. Networks do not mushroom accidentally only; they are also shaped by policies. As Haldane, the director of research at the Bank of England remarked: "Deregulation swept aside banking segregation and, with it, decomposability of the financial network. The upshot was a predictable lack of network robustness…"(2009, p.31).

[2]These are moments when, according to Minsky, financiers lay waste to the economy. A *Minsky moment* comes after a long period of boom, after much speculation via borrowed money; it happens when over-indebted investors are desperate to sell good assets to pay back their loans, causing huge drops in financial markets and big surges in demand for cash. Paul McCulley of PIMCO concocted it to describe the Russian financial debacle of 1998 (Lahart).

Prior to the financial crisis the European leaders failed to recognize the extent to which European banks were involved in the origination and distribution of toxic financial products. Financial sector practices have also obscured the size and dangers of the shadow-banking sector in Europe.

This crisis is also one of deep financial integration, which the intensity of the sovereign debt crisis mirrors glaringly[3]. In Europe, integration, with its financial component, was seen as a principal way to achieve catching up. And this approach entailed benefits, but it has also caused vulnerabilities, which are not to be linked with weak policies exclusively. For even countries which were quite prudent policy-wise and limited their external disequilibria were caught into the crisis maelstrom. Big bubbles and much investment in non-tradeable goods sectors occurred in several NMSs[4] following the opening of the capital account. Inadequate regulatory and supervisory arrangements operate in their case, too, against the backdrop of massive cross-border financial flows and the domination of local markets by foreign banks. Outside Europe and learning from previous crises, emerging economies tried to forestall shocks by the accumulation of foreign exchange reserves as a buffer (a high premium was attached to them); uphill financial flows were seen as a purposeful cost for the build up of a wherewithal capacity in the advent of unanticipated shocks[5]. Industrial policy aims, too, played a role in this respect.

1.2 The EMU: sub-optimality and institutional and policy weaknesses

Nowhere is the impact of *structure* more obvious than in the European Union, in the EMU in particular. For, in this area substantial cross border operations take place while national prerogatives in regulation and supervision, in tax and budget policies stay, basically, in national hands. In addition, the EMU is far away from an optimal currency area, as it was from its debut.

Challenges for the functioning of the EMU are rooted in the economics of currency areas. The optimum currency area (OCA) theory[6] says that the adoption of a single currency pays off when the monetary area is highly integrated economically and has the capacity to adjust quickly to asymmetrical shocks. Traditionally there are five core OCA properties namely:

[3] Reinhart and Rogoff's observation that deep financial crises are followed by sovereign debt crises is quite meaningful in the case of a highly integrated monetary union (2009)

[4] A Bruegel publication highlights this type of capital flow into the Baltic economies, Romania, Bulgaria (Becker et al., 2010, especially chapter 2).

[5] There is, arguably, an optimal degree of financial integration in the global economy in view of destabilizing capital flows (see also Stiglitz, 2010). A legitimate question is what should be done in the EU about it, since unhindered capital flows are a rule of the game in the Union.

[6] Mundell (1961)

wage and price flexibility, trade integration, cyclical convergence, factor mobility, and fiscal federalism, which are used to assess a success of an OCA area. In the EU wage setting continues to be done, predominantly, at the national level, and quite often at the sectorial level. This mechanism reinforces the relative inflexibility of the individual countries' labour markets. Within the euro-area real wages have tended to be downwardly rigid with a relatively high level of indexation. Moreover, although nominal interest rates had largely converged, there was a wide discrepancy among real interest rates of the euro zone members. Although business cycles synchronization has increased within the euro zone countries, much of it had to do with the fall in the amplitude of global business fluctuations, which benefited from low interest rates and low inflation during the past decade. But considerable structural differences remain at the euro-zone country member level. European labour mobility remains fairly limited, despite persistent differences in regional unemployment.

The current crisis has highlighted the inadequacy of existing institutional and policy arrangements and a stark fact: *that not all problems have a fiscal origin* (though they may end up, ultimately, as public debt). These arrangements have favored the accumulation of internal imbalances against the background of one-sided, inadequate policy tools. The "one size fits all" monetary policy of the European Central Bank (ECB) could not prevent excessive capital, frequently of a speculative nature, flowing into less developed areas of the EMU, in the EU as a whole. Resource misallocation and bubbles were stimulated in this way. Likewise, an increasing entanglement of mutual exposure among financial entities[7] has taken place while burden-sharing arrangements in case of a failed entity were missing. After the crisis erupted the ECB has turned into a *de facto* unwilling lender of last resort to various governments, which have tried to prop up financial institutions, be it indirectly (by accepting a wide range of bank collaterals). Contagion effects have reinforced the sentiment that institutional and policy arrangements are more than precarious. Systemic risks, which have been engendered by "too big to fail" cases, have been compounded by effects of a "too big to be saved"[8] syndrome.

The EMU is the only integrated area in the world which has a centralised monetary policy but favours a rather local (state) based approach to fiscal policy. The foundation for the latter was laid out in the Stability and Growth Pact (SGP), which acts as a coordinating instrument. However, all EMU member states breached its rules. Because the financial crisis has had a

[7] Banks outside of Greece, Ireland, Portugal and Spain hold 2 trillion euro in debt instruments from these countries, which underscores the systemic risk to the financial system if one or more borrower countries fails (data compiled by Jacques Cailloux, cited by Kanter, 2010)

[8] The overexpansion of some financial entities has dwarfed the capacity of home states to intervene in order to deal with systemic risks (Gros and Micossi, 2008).

very severe impact on national public budgets the very SGP rules have been put on the shelf. The cost of bank bailouts is quite staggering and the rise in public debts is pretty worrying[9]. There are several issues for debate in this regard. One relates to what could evolve as an unsustainable indebtedness of the EMU area. If the cumulated budget deficits (in the EMU), together with private sector indebtedness, turn into a substantial external current account deficit for the euro area as a whole, while its flaws persist, this situation would damage the status of the euro over the longer term[10]. Although, one could doubt the viability of the euro zone, in its current configuration, unless its flaws are addressed in a timely manner. Another aspect of the debt problem regards the relationship between those economies, in the EMU, which are running surpluses on their current account (primarily Germany) and those which are running persistent large deficits (such as Portugal, Italy, Greece). This financial crisis has shown the internal tension which such an uneven distribution of competitiveness (as a lack of sufficient convergence) in the EMU creates[11]. This inner major weakness has to be dealt with if the euro area is to avert highly damaging cracks. Given the existence of a common monetary authority, the ECB, and insufficient convergence in the euro zone, the argument for an EMU fiscal authority is compelling. This would create more room for manoeuvre for the mechanisms of fiscal transfers in the face of idiosyncratic shocks. It would also place less pressure on the ECB when dealing with regional divergences.

The regulation and supervision of financial markets is a huge policy issue in the EMU, in the EU in general. The distribution of responsibilities between home and host country and the inexistence of detailed burden-sharing arrangements in the event of a crisis has been a major handicap for the single market under conditions of deep financial integration[12].Under current arrangements, responsibility for the stability of financial institutions belongs to the supervisor of the country where they are headquartered whereas responsibility for the stability of financial systems belongs to the supervisor of the host country. This crisis reinforces the idea that a common rulebook, more integrated supervision, and a common framework for crisis resolution are all needed to match the degree of financial integration. On the other hand, the burden-sharing issue prompts national governments and supervisors to

[9] Apart from the effects of the current financial crisis (the cost of bail outs and big rises in government borrowing), another threat to sound public finances is the *ageing of population*. Reforms of the welfare systems are a must under the circumstances. Multi-annual budgetary frameworks are useful because they limit the scope for opportunistic government interventions in fiscal policy but adopting a longer-term vision for the EU public finances would require changes in the way fiscal policy is conducted.

[10] One would have to factor in the crowding out effect large public debts would exert on domestic business, which would damage private investment and, consequently, economic growth in the EU.

[11] For diverging competitiveness in the euro area see also "EMU at 10" (2008)

[12]As the de Larosiere et al. (2009) report notes, 'The absence of a sound framework for crisis management and resolution (with sufficiently clear principles on burden sharing, customers' protection, assets transferability and winding up) complicates the introduction of an effective and efficient supervisory system to avoid financial crises in the first place' (p. 76).

think more along national lines, in view of their accountability toward national taxpayers.

The bottom line is that, in order to function properly, be viable, the EMU should have solid fiscal/budget underpinnings; the latter would imply a common budget (common treasury) and the issuance of joint bonds –like in federal states (US, Canada, Germany, etc) when seen as monetary unions. Likewise, a common regulation and supervision of financial markets does make sense in the EMU. In practice however, this is very difficult to achieve because of political reasons.

1.3 EU Failures in Policy Action

In the face of crises the European institutions have almost always had a reactive approach, doing just enough to fix the problem in the short term. But, most of the time, decision-making has been too little and too late. At the root of this cause are conflicting national interests and inadequate institutional and policy arrangements. The two previous notable European initiatives, the Lisbon Strategy and the SGP have both failed because rules enforcement was weak, not to say largely inadequate. With domestic interests at stake, peer governments loathed penalizing each other. Proposals of automatic sanctions, triggered in the event of breaching the rules, have been consistently ignored. Another reason why those initiatives failed is because they minimized the role of major discrepancies among member countries at various levels: structural, economic and political and the cost incurred to fulfill the stated objectives.

The Europe 2020 Agenda aims at making up for past policy mistakes. In a global space where competition takes place, frequently, via zero-sum games, the EU economy has been consistently losing ground over the last decade. Although national policies do make a difference, the issue goes deeper than economics and concerns the whole range of values and norms embraced by a particular society.

1.4 Redistribution of power in the world economy and global imbalances

The Lisbon Agenda was enacted in 2000, as a EU response to Asia's growing assertiveness in the world economy. This is a resuscitation of the Lisbon Agenda, which was hardly a success. But one of the lessons of the past decade is that national policies make a difference. The results of Scandinavian countries, of Germany in undertaking reforms with a view of improving competitiveness are a proof in this regard.

Global imbalances enhance crises, which produce contagion effects. Can the EU push for a reform of the IFIs and of global arrangements which should limit dangerous global imbalances? The EU would gain in persuasion and bargaining power in the G20 to the extent it can deal with its own problems effectively. Yet, conflicting views and interests among EU member states reduce its internal cohesion and harm its power projection externally.

1.5 Policy lessons

There are lessons which policy-makers need to learn from this crisis:

- price stability is not sufficient for securing financial stability
- fiscal prudency is not sufficient for securing economic stability;
- unless financial markets are properly regulated and supervised they pose enormous systemic risks; this is particularly valid in a deeply integrated area such as the EU;
- private sector over-indebtedness creates systemic risks when it involves “too big to fail” financial entities;
- ways have to be found so that private investors bear the risks they assume (for the rescue programs have increased moral hazard); banks (their share-holders, bond-holders) should not take for granted that whatever they do tax-payers’ money stays behind them;
- deep financial integration demands stronger regulation and supervision at the EU level;
- because of deep integration contagion effects hardly leave one immune to the effects of a crisis;
- the incompleteness of the policy regime in the EU and the EMU’s flawed design;
- deep financial integration collides with the reality of national tax prerogatives;
- policy coordination needs to take into account EU-wide interests;
- trustworthiness among member states is essential for the sale of preserving the common public goods;
- national policies do matter for improving competitiveness, even when the room of manoeuvre is quite limited;
- we live in an increasing uncertain world, which diminishes policy effectiveness and asks for “policy space” (which includes fiscal space) in order to cope with “tail events” and non-liniarities[13]).

[13] For the importance of random events in our life see, among others, Mandelbrot (2004) and Taleb (2008).

2. The EU Policy Response: crisis management and reforming the EU (EMU) governance

The EU policy response to the financial and economic crisis has two components:

I. A crisis management undertaking, which has tried to mitigate the economic downturn and avert a financial meltdown. The ECB has been compelled to take an active role in this, which has gone much beyond its usual mandate. This exercise is impaired, however, by conflicting views regarding the root causes of the euro zone crisis. And the inexistence of an effective lender of last resort (since the ECB is constrained in its operations and the EFSF is quite weak) has magnified a confidence crisis which has engulfed the euro zone.

II. Measures aimed at reforming the EU's economic governance. This component is multi-faced and has several aims, namely:

- Fiscal consolidation by addressing the sustainability of pensions, health care and social benefits together with the adoption of national fiscal rules.
- Growth-enhancing structural reforms through higher employment and competitiveness
- The reform of the regulation and supervision of financial markets and restore the health to the financial sector.
- The set up of a permanent lending facility in the euro area-the European Stability Mechanism (ESM)

The reform proposals package was adopted by the European Parliament in late 2011. The first three directions mentioned above form the object of the Euro Pact Plus(EPP)[14], which has already been agreed by the euro area heads of state jointly with several non-member states[15]. Under the EPP proposals, each individual country would be responsible for the specific action it would choose to implement in achieving the commonly agreed objectives, monitored through a set of economic indicators. From a normative point of view the proposed measures could be seen as a step forward in improving the functioning of the euro currency area. But, big challenges remain. These relate to the implementation, coordination and enforcement of these measures as well as to filling in the gaps of the existing agreement.

The basic flaws of the EMU are not yet tackled resolutely. The EMU needs proper fiscal

[14] The EPP is viewed by many as reflecting, basically, a Berlin view, but it also relies on proposals made by the European Commission and the task force headed by the president of the European Council, Herman van Rompuy.

[15] These are Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. Hungary, the Czech Republic, Sweden and the United Kingdom decided to opt out from the EPP.

underpinnings and adequate regulatory and supervision arrangements of financial markets. The agreement to create the EFSF and the European Stability Mechanism (ESM) answer a necessity but is insufficient. And the EFSF has proved to be quite ineffective as a crisis management tool, as a means to prevent contagion. There are several issues to be noted about the ESM.

First, there is the issue of the individual member contribution to the ESM capital structure. Countries with lower credit ratings will end up paying up more to the ESM capital. Second, questions are raised over the perceived limited lending capacity of both EFSF and ESM. With Portugal being the third country, which asked for financial assistance in April 2011, the pressure has been moving to Spain and Italy. Under this scenario the existing EFSF lending capacity is strained much beyond the current limit. And its leveraging raises, itself, a host of technical problems. Third, the mechanism by which a loan guarantee is triggered in ESM places sudden pressures on domestic budgets in member countries, potentially worsening their budgetary positions.

The view that the proposed sovereign debt default mechanism will make the EMU, as it is now, more prone to crises has been validated by events[16]. A related problem is that the ESM could bring about another inconsistency, namely: the possibility of default, persistent imbalances and lack of proper fiscal arrangements (Munchau, 2010). This brings us back to square one, namely, the possibility of having a monetary union without solid fiscal (budget) underpinnings. Added to this is how to foster real economic convergence in the EMU.

2.1The EMU design needs fundamental repair (deceptive euro zone aggregate deficits)

European Central Bank (ECB) and Commission top officials note recurrently that the aggregate deficits of the euro zone (EMU) are inferior to those of the US and of other big countries (Japan is probably meant here since it has a public debt above 200% of its GDP). By this assertion they want to underline that the overall state of the euro zone is not worse than that of the US, or of other major economies; and that, consequently, it should not cause bigger worry. It is true that the US' public debt, which has gone over 95% lately, is above the aggregate level of the EMU; and the latter's budget deficit was ca. 6% of GDP in 2010, whereas the figure for the US exceeded 9% of GDP. However, these numbers need to be judged in conjunction with the roots of the euro zone crisis, of the sovereign debt crisis in the EMU. For, although the level of aggregate public debt does matter, the main cause of the euro zone crisis lies elsewhere, in its poor design. Until the eruption of the current financial

[16] Since it will introduce speculative dynamics into it, and an analogy is made with the Exchange Rate Mechanism (ERM) that preceded the start of the Eurozone (de Grauwe, 2010b)

and economic crisis, this flawed construction was obscured by cheap credit and cheap imports, by markets' myopia.

Economic history, of longer and recent vintage, teach us in this respect. Let us think of what differentiates the US and Canada, as federal structures, from the euro zone. A US sovereign debt crisis cannot be ruled out, in the long run, were its public debt continue to grow and markets lose confidence in the US dollar as a reserve currency. But an "American crisis" would rather occur as a massive depreciation of the USD, which would entail high domestic inflation. For the foreseeable future, US T-bills and bonds are among the safest investments in the world. Nobody assumes a disappearance of the US dollar, whereas not a few people are worried about the fate of the euro zone (and implicitly, of the euro), and various scenario are imagined in this regard. Moreover, markets have already priced in, more or less, tail events (default), contagion, linkages between sovereign debt and bank balance-sheets in the euro zone. Were an American state threatened by bankruptcy hardly anyone would doubt the existence of the US as a monetary union. Bank recapitalization in the US has proceeded better and more transparently than in Europe, and there are federal institutions for the regulation and supervision of financial markets across the Ocean. That their functioning has been inadequate, not least because of waves of deregulation (including the rescinding of the Glass Steagall Act of 1999 and the Commodity Futures Modernization Act of 2001), is a different matter for discussion. The US "single market" functions better then in the EMU. Such examples can continue.

A telling argument that markets do not pay much attention to EMU's "aggregate" numbers is that, since the start of the current crisis, they have increasingly discriminated among the sovereign debt of euro zone member countries. The interest rate convergence of the past decade was, arguably, a market myopia, a market failure, which brought about over-borrowing by state and private sectors and massive resource misallocation. This crisis has forced a wake up call, though this is happening with damaging overshooting, panics and vicious circles. Another question can be illuminating on aggregate numbers: how much fear-mitigating would be a diminishing external deficit of the euro zone were it accompanied by a growing cleavage, competitiveness-wise, between Germany, the Netherlands and the periphery (Greece, Portugal, Spain, Italy)in the euro zone? As this crisis shows external imbalances do matter in the EMU too.

The very setting up of the European Financial Stability Facility(EFSF) proves the weakness of aggregate numbers as an argument. An analogy could be made between TARP(Toxic Assets Recovery Program) in the US and EFSF. But TARP aimed at propping up financial entities; it was not set up because of the threat to the US as a monetary union. Instead, there are undisguised worries regarding the future of the EMU. Further, the very operations of ECB, of buying sovereign debt of member states, firm up the thesis that the EMU is lacking common fiscal (budget) underpinnings. The EFSF tries, inter alia, to relieve the ECB of an immense burden that has been bestowed on it as it operates as a "fireman", much beyond its traditional mandate of preserving price stability. It appears, however, that the EFSF, be it with substantially bolstered resources and a broader range of operations (including bank recapitalization and sovereign debt purchases in secondary markets) would be an imperfect substitute to a solid budget arrangement. Anyhow, EFSF needs to beef up its firepower in order to deal with a crisis that is infecting Italy and Spain.

Unfortunately, there is a major cognitive dissonance on fiscal (budget) integration among euro zone leaders. One approach, which is embraced by Germany, the Netherlands, Finland, etc sees euro-bonds as a culmination of a gradual process of integration, apart from political and legal impediments; the other approach sees euro bonds as an effective method to combat speculative attacks, and as a major step toward creating a solid fiscal complement to the common monetary policy[17]. The fact that there are such conflicting views on this subject, the lack of capacity to make decisions in due time (as it happened constantly since the euro zone crisis has started), the precarious intervention tools the EMU has at its disposals, make the aggregate deficits-based observation unconvincing. It may be that the deepening crisis would force a radical change of outlook and action, and trigger a speedy pace of fiscal integration in the euro zone. If not, it is pretty hard to see how the euro zone will survive in the current configuration. Asking governments to deflate once and again, for the sake of closing down productivity gaps and reduce overall indebtedness, is arguably not sustainable. Structural reforms may look nice on paper, but actual results may be too time consuming and uncertain and, thereby, further damage the cohesiveness of the EMU. The attempts of various governments to reinstate the gold standard during the inter-war period, in the past century, gives plenty of food for thought on this matter. And, by the way, at that time governments could still use their own national monetary policy instruments.

This crisis shows that incrementalism does not work. Fiscal rules are needed, as sanctions are. But fiscal rules are far from being sufficient; they cannot be a substitute for a solid fiscal arrangement, that must, arguably, include a common treasury. Appointing a finance czar for the euro zone, who should make judgments and recommend penalties, is not enough either. There are EMU countries (Ireland, Spain) that had pretty cautious budget policies and, relatively, low public debts before this crisis. And everything was blown out because of excessive borrowing on the part of the private sector, which invited a boom and bust cycle.

[17]A proposal made by the German Council of Economic Advisors indicates a shift in this direction (see Bofinger et al, 2011). This proposal is in the vein of the ides suggested by Depla and Weiszacker (2010)

The euro zone needs a rounded up common policy in order to survive. This policy would have to respond to asymmetric shocks, as it is done in the US and Canada via the federal budget, where unemployment insurance is provided; it would also have to deal with deep financial integration via a common regulation and supervision of financial entities as well as joint resolution mechanisms. For all this to operate there is need for fiscal integration, a common treasury. Even if Greece were to exit the euro zone in an orderly fashion and without entailing major contagion (is it possible?), the EMU would still need fiscal integration.

2.2 Fiscal Consolidation

The EU's sovereign debt crises, which ensued from the financial and economic crisis, have heightened concerns for *fiscal sustainability*. Governments' responses during this crisis and in other crises episodes show that, avoiding a systemic collapse necessarily entails burdening public debt. Thus, the policy of strengthened fiscal discipline should be seen in conjunction with policies addressing macroeconomic imbalances in the EU. A stronger SGP will be strengthened by improved surveillance and better data quality gathered from EU member states. The new system would rely on a much stronger compliance regime via "financial and reputational sanctions". The introduction of fiscal rules, as set out in the SGP, in national legislation is expected to enforce compliance with the SGP rules – which have been so often broken in the past.

The *preventive arm* of the SGP considers the sustainability of overall public debt, while the corrective arm targets a budget deficit path, which should bring down the debt to GDP ratio over time, in a consistent manner. The preventive component of SGP will limit public spending growth below the medium-term GDP growth until the target is met. It will also require that ''best practice'' budgetary procedures are implemented i.e. the adoption of multi-year budget planning, overview of fiscal targets by independent fiscal councils, the implementation of fiscal rules and increased transparency in statistics. These are useful innovations, which are likely to strengthen the preventive arm of the SGP.

However, there are changes to the corrective arm of the SGP, which would prove to be more challenging to implement in practice. The modification of the corrective component of SGP envisages the introduction of a 60% of GDP target for public debt, in addition to the 3% of GDP deficit limit. And, if public debt exceeded 60% of GDP, the country would be forced to bring it down at a pace of one twentieth of the excess over the previous three years[18]. These changes could raise several problems in practice:

[18] A breach of either the deficit or debt limits would trigger an infringement procedure and a fine of 0.2% of GDP if the country fails to comply. Rejecting a penalty proposed by the Commission would need a qualified majority in the Council of Ministers, i.e. by ''reversal voting''. ''Excessive imbalances'' of other economic indicators trigger a 0.1% of GDP penalty.

- Requiring a country to bring down its public debt during recession may be self-defeating, owing to the pro-cyclical nature of debt to GDP ratios.
- Since debt ratios are above 60% of GDP in most EU countries, collective action in reducing public debt could have a negative impact on the whole EU economic growth.
- Meeting the objectives of the revised SGP in the absence of a workable framework for bank debt resolution and recapitalization could be challenging for all EU members. Both targets could be easily overshot in circumstances when some private institutions,deemed too big to fail, would need to be bailed out by national governments.
- Countries with high debt/GDP ratio could face credibility problems in meeting the targets at the required speed, as their policies would face serious economic and social constraints. This could impact their borrowing costs for a long time, hampering their fiscal adjustment program.
- The EC's penalty system might not be credible as some of the indicators monitoredare not policy variables and thus cannot be controlled by government policy (Manasse, 2010).

The EPP places a disproportionate weight on fiscal adjustment issues. But, fiscal indiscipline was not a cause of the crises in Ireland or Spain, for instance. Moreover, the risk of almost all EU countries behaving the same, i.e. enforcing the Maastricht criteria on public debt and deficit, could have a powerful recessionary bias in Europe.

Except Hungary, NMSs do not have large public debts. But budget deficits have gone up dramatically in the wake of this crisis. Moreover, not a few NMSs were running meaningful structural deficits prior to the crisis, based on their existing economic growth model at the time. Consequently, the Baltic countries, Bulgaria and Romania have had to implement their fiscal consolidation programs because of the permanent loss of output and impairment of economic growth --against the backdrop of a highly unfriendly external environment that has been entailed by the turmoil in financial markets. But, as Becker et all (2010) note, fiscal consolidation has to take into account the risk of adding public deleveraging to the ongoing private deleveraging, a factor which could harm economic recovery.

NMSs would benefit hugely from a high degree of absorption of EU structural and cohesion funds. These resources would offset the influence of expenditure reduction on aggregate economic activity while giving a boost to public investment in a period of economic distress. The availability of these resources would help prevent fiscal consolidation becoming pro-cyclical during a recession. The IFIs and EU supported adjustment programs in NMSs have, arguably, not paid sufficient attention to the strategic role of EU structural and cohesion funds in this new context.

For NMSs the introduction of fiscal rules is desirable, as it would discipline fiscal policy and remove, to a great extent, the influences of political business cycle on the economy. But, the limitation of budget deficit at 3% of GDP could be a serious constraint at times, given the nature of mandatory expenditure. For instance, it matters a great deal how contributions made to private pensions schemes, which are part of the pension system reform, are accounted for in the measurement of the structural budget deficit. The risk is that such legislative changes could be reversed in extreme circumstances if the degree of public endurance with fiscal reforms wears thin.

2.3 Implement growth-enhancing structural reforms

The EPP proposes two main areas where improvements could be made: labor market and competitiveness. It has to be noted that the same areas were singled out in need of enhancement in the Lisbon 2010 Treaty. However, progress in achieving those objectives was only marginal at best, in most of the EU economies. The new proposals aim at remedying this. But, in practice they could raise more problems and lead to growing discrepancies among EU economies.

2.3.1 Increasing Competitiveness

The EPP suggests assessing wage and productivity developments by looking at relative unit labor costs (ULC) in euro area countries and their trading partners. Imbalances between costs and productivity are supposed to be resolved through wage control growth, product market liberalization, improvement in R&D, infrastructure and innovation as well as the business environment.

There are problems with the way in which proposals have been made. First, the one-size-fit-all logic applied across EU countries could have unintended consequences. Witness the effects that a single monetary policy had on EU peripheral economies during the boom years. Then, economies such as Spain or Ireland would have needed higher interest rates in order to prevent domestic macroeconomic imbalances building up. The same reasoning applies to the stated objectives of EPP on competitiveness. Initial conditions do matter and, an attempt to somehow correlate unit labor costs[19]across EU member states using current

[19] There are various measures of competitiveness indicators, which often yield different results. Although proposals by the EPP suggest a range of ULC indicators to be used for various sectors of the economy, these still remain just one measure of competitiveness – most likely chosen because they facilitate comparisons across EU countries on a similar basis.

indicators as benchmarks, have the potential to lead to more destabilizing conditions in the future. Besides, economic growth is likely to slow further following the introduction of these measures, at a time when growth pick up is paramount for the success of country stabilization programs.

Second, competitiveness is not a policy instrument, and it cannot be influenced unambiguously and directly by governments' economic policy. The authorities could strive to create premises for an economy to develop but the ultimate outcome is a complex result of a market given context. NMSs, for instance, have traditionally benefited from lower labor costs but other factors such as inappropriate physical and skilled human capital in various sectors, or a low level of R&D impact adversely on their long-term competitiveness. Moreover, building up higher stocks of capital takes time and implies fast economic growth rates. For most NMSs a major policy issue is how to enhance resource allocation toward tradable sectors. For this crisis has revealed flaws of the precrisis growth model.

Not least, the focus on ULC as a measure of a country's competitiveness might be seriously misleading. Felipe and Kumar (2011) suggest that there are conceptual problems with it. If ULC are considered, then unit capital cost (UCC), that is the ratio of profits to capital productivity, would also have to be looked at. The authors show that capital productivity has been displaying a declining trend in the EU. Moreover, a ULC for tradable goods comparison across EU countries could be misleading because of the complexities of export products, which vary across the EU economies. NMSs tend to export lower value added and lower technology products while Germany, for example, exports over 12% of the world's top 10 most complex products. Thus, if Germany were supposed to provide a benchmark for competitive policies in the EU, based on ULC, it would in fact distort the whole picture and impose unfounded constraints on NMS' policies.

There would also be major implications for national policies, which are asked to undertake corrective measures. Governments could become more involved in the management of the economy, in mediating between social partners for the sake of achieving competitiveness targets. And as competitive devaluation can be damaging overall the same could happen with "competitive" wage controls throughout the EU.

2.3.2 Fostering Employment

The EPP suggests each national state would have to implement policies aimed at increasing participation rate, lowering labor tax rates or increase lifelong learning. While from a normative point of view such policies are desirable, their pursuance might yield the expected outcome in the long term only. The labor market is far from being flexible across EU countries. Apart from labor market restrictions – which still apply to some NMSs such as Romania or Bulgaria, five years after they joined the EU – labor mobility within the EU remains low compared to the US for instance. Citizens of NMSs face relatively high migration costs, given their earning power. A uniform labor market reform across EU economies could have asymmetric effects as labor, being mobile, could shift towards most developed economies where wages are much higher. The richer EU countries are also devising means to attract highly skilled labor from poorer countries.

2.4 Financial Sector's Regulation and Supervision Reform

European policy-makers are advancing with an overhaul of the regulatory and supervisory structures of financial systems, including the parallel (shadow) banking sector and rating agencies. Harmonization of rules is not a sufficient response to the crisis, since the very content of regulations and supervision needs radical change[20]. A reformed regulatory and supervisory framework would observe basic principles such as regulation of all financial entities (including the *shadow banking sector, hedge funds and private equity funds*), higher capital and liquidity adequacy ratios, capping leverage, bringing derivatives into the open and having their trading regulated, preventing regulatory arbitrage, transparent accounting rules, and addressing systemic risk.

In the EU there is need to strengthen the regulation and supervision of major financial groups, which operate cross-border. The European Systemic Risk Board (ESRB) together with the new supervisory authorities should bring a decisive plus in this regard.

In September 2011 Britain's Independent Banking Commission released its report, which suggested that the financial system would be more resilient to future crises if banks' retail were ring-fenced as against investment units. But this proposal comes short of the proposal put forward by Paul Volker, the former Federal Reserve Chairman, which suggested a complete separation between the two bank activities, as they were prior to the abrogation of the Glass-Steagall Act of 1933. As a matter of fact, the "too big to fail" issue is still unaddressed by policy-makers and, ironically, the unfolding of the financial crisis has resulted in bank consolidation, which entails a heightened moral hazard problem (Johnson and Kwak, 2010)[21]. Global competition and the fear of regulatory arbitrage are not peremptory arguments in this respect. The persistence of this problem rather reflects the

[20] This is what comes out prominently from the de Larosiere et al. (2009) report and the Turner (2009) report (in the UK), from documents of the European Parliament and directives of the European Commission, the Monti (2010) Report, etc.

[21] As put by Goldstein and Veron (2011) this issue is more challenging in Europe owing to a higher concentration of banking markets than in the US, general reluctance to let banks fail, the interdependence between banking and political systems and, not least, nationalism.

power of vested interests.

One large component of the policy response namely consistent public sector bailouts of the private sector, notably of the banking sector, continues to pose more questions than it solves. The cross border structure of European bank operations and the years of resource misallocation have left many banks in Germany, France or Austria with a heavy exposure to peripheral EU countries and NMSs, i.e. those countries which now undergo painful adjustment programs. There is now a vicious circle emerging in which the refinancing of debt from countries with lower credit ratings is being done indirectly by those euroarea member countries which have a solid interest in protecting the health of their national commercial banks' balance sheets. But the onus of adjustment is almost entirely put on the taxpayers of the countries in distress, which raises a host of practical and moral issues. A legitimate question therefore arises: is such an arrangement appropriate and sustainable (does it take into account the need for burden-sharing[22]?).

The EU can acknowledge an insolvency problem and come up with some form of debt restructuring for distressed sovereigns whose public debt is on an unsustainable path[23]; it would imply a restructuring or even closing down insolvent European banks[24] (until recently stress tests performed across European banks have failed to incorporate extreme scenarios, such as default by a member state, simply because such a default is perceived to be politically inconceivable and would trigger powerful contagion effects). This option would also go some way in addressing the so-called 'burden sharing' issue among EU countries, since it was the banks from creditor EU members which provided loans that subsequently turned bad, in the first place[25]. Clearly, such an action asks for a political decision in the EU donor countries, in Germany in particular[26].

The 50% haircut applied to Greek sovereign debt is a breakthrough in this regard and forces banks to build up their capital, but it also creates a precedent in terms of capacity to contain

[22]Burden sharing can be seen through two pair of lenses. One regards whether private investors (bond-holders) share into the costs of debt restructuring. The other one refers to the distribution of costs among EU member countries. Hence arises the political sensitivity of this issue. Both perspectives imply the impact of an eventual sovereign debt restructuring on banks' balance sheets.

[23]The prevailing common view at various EU institutions, including the ECB, is that a country, which commits itself to a credible adjustment program, cannot be considered insolvent and thus should not be placed in a position to restructure its debt. What the ECB has seemed to fear mostly is contagion brought about by a sovereign debt restructuring, be it done in an orderly manner.

[24] See also Darvas, Pisani Ferry and Sapir (2011)

[25]The possibility of adoption of collective action clauses (implying *haircuts*) by euro-area members, involving agreements between debtors and creditors over debt restructuring, has been explored at the European level (see BiniSmaghi, 2010)

[26]For the political and social climate, which goes against such a solution, see also Guerot and Leonard(2011). The spectacular political advance of the "True Finns Party" in Finland speaks volumes about the contradiction between economic logic and political reality.

contagion. For sovereign debt restructuring[27], however orderly it can be, may not prevent contagion, which would have its cost open-ended. This is, arguably, what the ECB fears mostly in a rushing of things. But putting off the day of reckoning may not be less costly.

The crux of the matter seems to be how to make private investors accept haircuts while reopening financial markets to the countries in financial distress by making their adjustment programs as credible as possible. This is a catch-22 dilemma. Coping with this dilemma brings the issue of fundamental repair of the EMU design to the fore (see 2.1).

2.5 Dealing with global imbalances

The current crisis has reinforced one of Keynes' intellectual legacies, which was enshrined in the Bretton Woods arrangements —namely, that highly volatile capital flows are inimical to trade and growth and that financial markets are inherently unstable. As a matter of fact restraining financial flows is a way to solve *the impossible trinity*, which says that an autonomous monetary policy, stable exchange rate and free capital flows cannot be achieved concomitantly[28]. The increasing number of emerging economies which resort to capital controls (in order to stem speculative flows) is quite telling about actual dynamics in the world economy. The IMF’s policy turnaround in this respect is also noteworthy.

3. Issues Pertaining to NMSs

3.1 Financial stability in NMS[29]

Financial stability in NMSs relates to, on one hand, crisis management in the euroarea and, on the other hand, to specific concerns. Crisis management in the euroarea gives a very high profile to contagion. Let us keep in mind that financial markets in NMSs are heavily dominated by foreign groups and their economies are significantly ‘euro’-ised.

There are several means to enhance access to liquidity and mitigate solvency threats at a supra-national level; many of remedies have been implemented during the crisis: rules on convergence of deposit guarantees, which should prevent beggar-thy-neighbor policies; medium-term financial facilities; IFIs credit lines and investments. Two avenues to improve the EU’s support to NMSs deserve discussion: swap lines between the ECB and central

[27] Debt restructuring distinguishes between reprofiling of bonds, with their maturity extended, and write-downs (haircuts) on the value of the debt. The latter would impact significantly on not a few banks’ balance sheets, which would need recapitalization.

[28] This is shown, analytically, by the Mundell-Fleming model.

[29]This section draws on Becker at al (2011).

banks of non-euro area countries; a broadening of ECB range of accepted collaterals to national currency denominated bonds issues by non-euro NMS countries. These two measures, which would have helped to ward off euro liquidity shortages, were considered but not implemented at the height of the crisis.

Preventing credit booms will be an issue again in NMSs, sooner or later. Instruments that can be used are: counter-cyclical capital and reserve requirements; dynamic provisioning against expected losses; limits on leverage and maturity mismatches; discretionary macro-prudential measures under the guidance of newly created macro-prudential supervision bodies such as the European ESRB. The difficulty for the NMSs is that this toolbox mostly applies to countries where credit is in the hands of national banks or autonomous local subsidiaries of foreign banks. It is not likely to be effective in countries where credit is mostly in the hands of foreign bank branches or lending can be outsourced to foreign entities of the banking group (i.e. the parent bank or a subsidiary in another country). Coordination among supervisors can be a response and should continue being developed but calling for coordination is no solution when institutions participating in it have different, possibly conflicting mandates and incentives. This is where the role of the ESRB comes prominently into the picture.

NMSs cannot rely on capital controls as the single market prohibits such measures[30]. Therefore, the risk of destabilizing capital inflows leading to credit bubbles has to be addressed through other means, which may include action on the demand for credit. Regulatory and tax instruments can, for example, be used to tame mortgage credit when deemed excessive from a macro- prudential point of view. All such measures, in order to be effective, would need to be adopted on a supra-national level.

3.2 Euro Adoption

The crisis in the euro area shows that removing the option of adjusting a nominal exchange rate may be very costly in terms of fiscal adjustment if it is not accompanied by efforts to limit excessive demand in the private sector, even if fiscal policy is broadly in order. However, limiting excess demand in the private sector is not easy to achieve for national governments that have surrendered their power over monetary policy in an environment with free capital mobility. It is noteworthy that housing and credit booms in Ireland and Spain, and in several NMS have been quite similar, suggesting that the fall in real interest rates as the result of financial integration and economic catching-up matters both inside and outside the euro

[30] As some countries use waivers to restrict what they consider to be destabilizing labor inflows a similar logic could apply when EU countries are faced with destabilizing capital inflows. Tax tools could be used in order to diminish such inflows. Obviously, this would require a flexible interpretation of EU rules.

area. Euro outsiders should therefore be careful before fixing the exchange rate and should allow as much flexibility as possible on the way to euro adoption; they, in any case, should introduce measures preventing the emergence of unsustainable credit booms. But host country authorities may not be effective in this effort because of deep financial integration. However, they are not completely impotent: measures such as dynamic provisioning, using loan-to-value ratios, increasing minimum reserve requirements can provide buffers against excesses.

The crisis in the euro zone, in particular, the competitiveness problems of Spain, Portugal and Italy and the inability of these countries to adjust their competitiveness inside the euro area highlights a big policy issue: Should the criteria for the optimal currency area (OCA) be fulfilled *ex ante*, i.e. before a country enters the euro area, or is it sufficient to expect that they will be fulfilled *ex post*, i.e. euro admission will create structural changes in the economy that will make the country suitable to the monetary union, even if it had not been before? The inability of southern EMU countries to adjust to competitiveness pressures inside the Euro zone indicates that it is wise for euro aspirants if OCA criteria are satisfied *ex ante* and there are policy instruments to guide the eventual need to adjust real exchange rate divergences *ex post*.

The NMSs form a multi-colored cluster; some of them are better integrated in EU industrial networks and show balanced trade accounts, while others (including Romania) have skewed trade imbalances and much of capital inflows went into non-tradable sectors. Therefore, their chances of joining EMU are not similar.

3.3 Tax Harmonization Across the EU

One proposal of the EPP is for the EU members to explore the opportunity for tax harmonization. Agreeing to corporate tax harmonization across EPP countries, for instance, would go against the competitiveness concept. Removing incentives based on different taxation systems would be a major setback for less developed EU countries, such as NMS, in their efforts to attract investment. Tax competition policies are an important instrument in countries, which are involved in the catching-up process and thus need to build up capital because it is a useful tool in luring foreign investment.

3.4 The Threat of Low Equilibria and Pitfalls of a One Size Fits All Economic Policy

The current financial and economic crisis has revealed flaws of the growth model that depends on massive external borrowing and inattention paid to resource allocation. In some NMSs much of investment went into non-tradable sectors, which created the framework for unsustainable growth and hid structural budget deficits. Very painful corrections of imbalances are underway in several NMSs. These adjustments need to consider a changing international (European) context regarding credit terms, capital flows, trade competition, investing in education and, not least, the challenge of enhancing the growth of tradable sectors when national policy is constrained by EU rules.

The euro pact brings novelties regarding fiscal discipline and policy coordination. But unless it pays thorough attention to the needs of emerging (low income) EU economies the latter may get stuck in low equilibria situations (Portugal's experience is quite relevant in this regard). EU funds absorption has to increase manifold in order to help develop their infrastructure, raise fixed capital investment in tradable sectors. Would foreign banks that operate in these countries change their lending proclivity and be more forward oriented as stakeholders? It is true that there is a sort of economic recovery in NMSs and some of them are bouncing back impressively by relying on exports. But sustainable high economic growth rates, liable to achieve convergence, ask for much more as a recipe for economic catching up. One should also bear in mind significant differences among NMSs; some of them (the Czech Republic, Hungary, Slovakia, Poland) are better integrated in European industrial networks and perform better trade-wise.

The threat of being caught in a region of low equilibria has to be judged in conjunction with pitfalls of a one size fits all economic policy. For example, very low inflation (as Maastricht criteria demand) is pretty hard to obtain in an emerging economy[31]; it could even constrain growth. Or take the policy guideline of imposing limits to current account deficits (in the vicinity of 5% of GDP) in the countries that signed up to the EPP. If FDI is substantial and goes prevailingly into tradable sectors there should not cause much worry; in such a case a current account deficit which may go beyond 10% of GDP is not an unwelcome imbalance.

4. Other Issues to Ponder On

Disentangling private from public debt has become an overwhelming issue in the EU in view of its deep financial integration. Private sector (bank) debts are making up enormous contingent liabilities on public debts when bankruptcies are not tolerated (not to mention the

[31] Not least because of the Balassa-Samuelson effect and the prospects of further rises in the relative price of basic commodities (assuming that their consumption does no go down drastically)

moral hazard problem). This is one of the revelations entailed by the current crisis. And the inability to disentangle the myriad of intertwined debts will impact, negatively, on fiscal policies for years to come. Even now this feature of deep financial integration seems to be under-estimated by some. What is worrisome is that bank consolidation would preserve the hostage relationship governmental budgets are held into. Ways must be found to make sure that a golden rule of market economy operates, namely, that investors bear the risks they assume and losses are not socialized[32].

Fiscal rules, surveillance and peer pressure are not enough for strengthening the cohesion of the EMU, of the EU in general. A handicap in the EU is linked with the political reality that taxpayers are, ultimately, national citizens. Can "common goods" (including the euro) be protected unless "common resources" (the EU budget?) are more substantial? Can resolution schemes and orderly restructuring schemes of sovereign debts be devised so that they compensate the smallness of the EU budget and complexity of the EU decision making process? Can the EU policy-makers use additional instruments in order to foster more real convergence in the EMU, in the EU as a whole? Is there room for strengthening policies at EU level?

Were this crisis come to an end, would a deflationary bias in the conduct of monetary policy appear in view of the willingness to prick bubbles in their infancy? On the other hand, would not it, by fostering less instability, support long-term growth? In a way, answering this question is analogous to deciding on a proper speed of implementing Basel III: for a too fast implementation could stifle recovery; on the other hand, a too slow implementation would create prerequisites for a new crisis.

Does size matter for judging fiscal risk? It appears it does. Large economies are, seemingly, considered to have a bigger capacity to resists shocks; they are, potentially, more resilient. Resilience (ability to withstand external and internal shocks) will increasingly be a principal policy aim in the years to come.

What would be the impact of new technology for circumventing rules (ex: *high-frequency trading*)? Regulators and supervisors need to take it into account as well, when thinking about financial stability. The latter can be linked also with the capacity of economy to withstand effects of natural disasters, with social strain. Demographics, too, play in a role when it perturbs inter-generational balance and, consequently, fiscal equilibria.

The years to come will quite likely be accompanied by an increasingly uncertain environment; complexity will also be on the rise. These circumstances advocate a more simple, resilient financial intermediation system, for the sake of its own stability. If this does

[32]"…the current imperfect world where bondholders of banks and nations are shielded from suffering any pain cannot last. Something has to give"(Milne, 2011)

not happen and global imbalances persist, more fragmentation is to be expected, with societies turning, probably, more inward looking. This will have profound implications for the global system. It may be that, in view of the lessons of financial crises and of the need to lend to economies more resilience, there is an optimal size of openness (trade and finance-wise). This implies that firms need to think globally and operate selectively as a means for mitigating risks[33]. It may also be the case that we will end up with a three blocs-based financial system as a means to maintain a relatively open global system.

"Japanization" of EU economies is a distinct possibility in view of the legacy of this terrible crisis and power redistribution in the global economy. One should also bear in mind the erosion of the middle class that has been taking place during the last couple of decades in the US and in numerous European countries; this process complicates adjustment and reforms, in general.

Final Remarks

Structure and *networks* are key in understanding the roots of the current crisis and the tension in the EU (EMU). Such a perspective reinforces the rationale for a reform of the EU economic governance and a radical overhaul of the EMU institutional and policy arrangements. As this crisis indicates it is not only fiscal rules and their compliance with that a proper functioning of the EMU hinges on. Flaws of financial intermediation, growing imbalances stemming from the dynamics of private sector saving and investment flows, inadequate regulation and supervision of financial markets, and, not least, inadequate budget arrangements (the lack of a common treasury and missing instruments in combating asymmetric shocks) have played a major role in triggering the sovereign debt crisis in the EMU. The overexpansion of financial institutions and their investment behavior are to be highlighted as well. Consequently, a reform of the EU economic governance has to deal with fiscal rules and compliance, macroeconomic disequilibria and competitiveness gaps, the regulation and supervision of financial markets; the design of the EMU needs to be thoroughly remade. In the meantime, firm crisis management has to be used in order to prevent a break down of the euro zone. The need to tackle global imbalances and overhaul international arrangements is to be mentioned in this context.

[33] Other catastrophic events (like the Fukushima disaster) highlight the risks of over-dependency on various sources of supply.

Fostering real economic convergence remains a huge challenge in the EMU, in the EU as a whole. A threat for the EMU is a growing cleavage between its northern tier and its southern tier, with the latter becoming, possibly, mired into vicious circles, incapable of overcoming the impact of fiscal consolidation in a hostile external environment[34]. Another chasm could deepen between older EU member states and some NMSs. Can Europe 2020 provide a light in this regard? NMSs have a deep stake in EU governance reform since they cannot escape the impact of EU wide externalities and the functioning of their economies depends on the rules of the Union.

[34] A sort of "Mezzogiornification" of the South of the EMU, but with more tensions than those envisaged by Krugman (1993, p.80) and more threatening for the viability of the Union. See also Amato et.al (2010)

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