12. The 2007-Financial Crisis – a Euro-Pean Perspective

Juan Ayuso and Roberto Blanco

12.1. Introduction

In the summer of 2007, the collapse of a relatively small segment of the financial markets in the USA – the so-called subprime mortgage market – triggered a severe economic, financial and fiscal crisis that affected mainly, although not exclusively, the advanced economies. Six years later, the crisis is still not over, in particular in Europe and more concretely in the euro area, which is the focus of this chapter. At the euro area level, real GDP in 2012 was below its 2008 level. At the country level, the IMF expects Greek GDP still to remain 13 pp below its 2008 level by 2017. According to the same projections, by that date Spain and Italy would be about to recover their pre-crisis GDP levels. Unemployment affects nearly 12% of the working population, more than 3 pp above the figure at the end of 2008. But the increase has been around 19 pp in Greece, 11 pp in Spain and 8 pp in Portugal. In the financial realm, according to the European Commission, banks across the European Union had received financial support from their governments to the tune of nearly 13% of GDP between 2008 and 2011, including capital injections, balance-sheet clean-ups and guarantees for bond issuances. Several entities have been resolved and not surprisingly, faced with recession, high unemployment and financial instability problems, several governments have seen their current and contingent liabilities soar and then feed back into growth and financial stability problems. Three countries (Greece, Ireland and Portugal) are under a fully fledged EU-IMF financial assistance programme since their governments lost market access, and a fourth one (Spain) is under a specific EU programme to assist the restructuring and recapitalisation of its financial system. Last but not least, the relatively high degree of financial integration attained in the euro area has been seriously dented. This has posed a problem to the European Central Bank, whose expansionary monetary policy measures in respect of households and firms in the different Member States have been quite uneven due to the impairment of the monetary policy transmission mechanism.

In their extremely rich review of the financial crises of the last eight centuries, Reinhart and Rogoff (2009) maintain that the economics profession has an

---

1 The views in this chapter are the authors’ views. These views may or may not coincide with those of Banco de España or SUERF. We thank the editors of this volume for their friendly and very much appreciated comments, Víctor García-Vaquero for his invaluable help with the review of the literature and Fernando Nieto and José A. Cuenca for outstanding research assistance.
unfortunate tendency to time myopia. By looking at each fresh crisis through the lens of just the latest data, the illusion is created that “this time is different”. While not disputing this idea that most crises share many common features which the passage of time tends to blur, we believe that the financial crisis that the euro area is still undergoing shows several relevant idiosyncratic components that deserve close attention. In a nutshell, the main thrust of this chapter could be summarised by noting that while from a country-by-country perspective the current crisis in Europe could perfectly match the general pattern identified by Reinhart and Rogoff, the fact that those countries were part of a monetary union that was not designed to deal with any kind of crisis, be it financial, economic or fiscal, added an extra dimension that has rendered the crisis more severe and more lasting. To be clear, we are not raging against the euro. On the contrary, Our conclusion is that an overhaul of the governance of the euro is urgently needed to better underpin the very positive contribution that EMU has made and has still to make to the welfare of European citizens. Some promising steps have already been taken in this direction, but much remains to be done.

Against this background, the chapter is organised as follows. Section 12.2 provides a short overview of financial crises by summarising the main findings of the literature in that field. The focus is on the financial crises over the last 50 years. Section 12.3 seeks to frame the main financial and economic developments in the euro area before the 2007 financial crisis. Section 12.4 reviews the unfolding of the crisis and its highlights, while the main elements of the institutional set-up of the euro that propelled it are analysed in Section 12.5. Sections 12.6 and 12.7 summarise the main progress made and proposals to deal with the flaws identified, while Section 12.8 offers the main conclusions of the chapter.

12.2. A SHORT OVERVIEW OF FINANCIAL CRISSES OVER THE LAST 50 YEARS

Financial crises are recurrent episodes in both emerging markets and developed countries. There are many types of financial crises including banking, balance-of-payments (or sudden stops), inflation, currency, stock market and debt (external, domestic or sovereign) crises. The literature on financial crises is largely segmented by types of crises. Many papers focus on the identification of these episodes using different methodologies (including both quantitative indicators and event analysis techniques, depending on the type of crisis) and analyse their main patterns in terms of the duration, the impact on macroeconomic and financial variables, the policy reactions and the main causes. Useful references include Minsky (1975) and Kindleberger (1976). More recent studies include Reinhart and Rogoff (2009), which reviews the history of financial crises over the last eight
centuries using a unique database, and Laeven and Valencia (2012), which focuses on financial crises between 1970 and 2011. Claessens and Kose (2013) provide a selected survey of this literature. Broadly speaking, the available studies on this field tend to stress that, although financial crises come in many different forms, they share some common elements. In particular, they often tend to be preceded by asset booms, an excessive debt accumulation by one or more sectors (governments, banks, corporates and consumers) that make the economy vulnerable to a crisis of confidence and by a booming economic period. Reinhart and Rogoff (2009) argue that, in many episodes, what they call “this-time-is-different syndrome” is present before the crisis. They explain this syndrome as the (obviously wrong) belief that financial crises only happen to other people in other countries at other times. The boom that we are currently envisaging, however, is built on sound fundamentals.

Once the crisis unfolds, one or more of these elements are often observed: substantial changes in credit volume and asset prices, severe disruptions in financial intermediation and the supply of external financing to various agents of the economy, large balance sheet problems and large scale government support.

The literature on financial crises shows that these episodes tend to come in waves and concentrate in some regions around specific events. Examples of crisis waves in the recent period include the Latin America debt crises, in the 1980s; in the early 1990s, the Nordic banking crises and the European Exchange Rate Mechanism currency crises; in the late 1990s, the East Asian crises; in the 2007-2009, the suprime crises; and the sovereign debt crisis in Europe that started in 2010.

This literature also shows that there is some overlap between the various types of crises. More specifically, currency crises tend to overlap with banking crises – the so called twin crises (Kaminsky and Reinhart (1999)). Additionally, sudden stop crises sometimes overlap with currency crises and with sovereign crises – triple crises. Out of the 431 financial crises reported by Laeven and Valencia (2012) over the period 1970-2011, they consider 68 as twin crises – i.e. they involved two types of crises- and 8 are triple crises – i.e. they involved three types of crises.

Some papers show that there are a number of common patterns too in the sequencing of financial crises. In particular, the evidence provided shows that banking crises tend to precede currency and sovereign debt crises (Reinhart and Rogoff (2011); Laeven and Valencia (2012)). For example, in the database of Laeven and Valencia (2012) 21% of banking crises are followed by a currency crisis in the same country within three years, whereas the opposite happens in the 16% of the banking crises.

---

2 Others, such as Shiller (2000), use the term “new era economic thinking” to express a similar idea, i.e. the popular perceptions during speculative market expansions that the future is brighter or less uncertain than it was in the past.
Laeven and Valencia (2012) identify 147 banking crises, of which 13 are considered borderline events, over the period 1970-2011. They show that many countries experienced more than one of these types of crisis during this period. They also find that crisis cycles frequently coincided with credit cycles. More specifically, out of the 129 banking crises episodes for which credit data are available, 45 were preceded by a credit boom. They also identify 218 currency crises over the same period and 66 sovereign crises, of which 10 and 3 episodes occurred during 2008-2011, respectively.

Financial crises have generally large economic costs, although the impact varies considerably depending on the type and depth of the crisis. Claessens, Kose and Terrones (2013) show that recessions associated with financial crises tend to be unusually severe, result in much larger declines in real economic activity and their recoveries tend to be slow.

Generally, banking crises tend to have higher macroeconomic costs and tend to last longer. In their analysis of the banking crises between 1970 and 2011, Laeven and Valencia (2012) report that the average duration was 2 years, the average output loss was 23% of GDP and the average fiscal cost was 7% of GDP. Interestingly, they find that in advanced economies output losses were larger than in emerging and developing countries. They argue that banking crises are more disruptive for advanced economies because they have deeper financial systems. By contrast, they find that fiscal costs are larger in developing and emerging economies.

In their analysis of post-World War II bank-centered financial crises in advanced economies (excluding the episodes after the subprime crisis), Reinhart and Rogoff (2009) show that the average per capita GDP growth was negative for the starting year of the crisis and for the following two for the five more severe systemic crisis (referred to as the “Big Five”) that include the following: Spain (1977), Norway (1987), Finland (1991), Sweden (1991) and Japan (1992). The largest output loss (peak-to-trough) in real per capita GDP was observed in the 1991 crisis in Finland with around 12% fall. This crisis also lasted the longest (4 years). They also show that these crises had a profound impact on asset prices. Declines in house prices in real terms was highest again in the 1991 crisis in Finland (around 50%, peak-to-trough), but was also significant in the 1987 crisis in Norway and in the 1992 crisis in Japan (around 40% and 35%, respectively). Contraction in equity prices was the highest in the 1977 crisis in Spain (around 65%, peak-to-trough). These severe systemic crises had also a profound impact on the fiscal positions of countries. For instance, the cumulative increase in real public debt in the three years following the start of the crisis was around 180% in the 1991 crisis in Finland, and more than 100% in the 1977 crisis in Spain.
For the other 13 post-World War II bank-centered milder financial crises in advanced economies analysed by Reinhart and Rogoff (2009), per capita GDP growth fell but was, on average, positive during the crisis.

As regards the most recent financial crises, Reinhart and Rogoff (2009) show that the subprime crisis that started in 2007 was more severe for the United States than the average Big Five crises in terms of output losses and contraction of house and equity prices. Using a composite index of crisis severity that takes into account the number of crises occurring at the same time in a particular country, they also show that the post-2007 episode has been unique since World War II in terms of both its severity and global scope. Laeven and Valencia (2012) also show that the number of banking crises after 2007 is unprecedented. In the period 2007-2011 they identify 17 systemic banking crises and 8 borderline cases (of which 13 and 7 take place in Europe, respectively). Some of these crises rank among the costliest crises since 1970 in terms of both output losses and fiscal outlays.

12.3. The Euro Area Financial Markets before the Crisis

The global roots of the current financial crisis have long been discussed (see, among others, Zingales (2008); Brunnermeier (2009) or Kashyap, Rajan and Stein (2009)). Most authors tend to agree that the experiences of the Asian – late 1990s – and the ICT – early 2000s – crises led to a “savings glut” (see Bernanke 2005) as governments in emerging economies reined in public deficits, and corporate investment in advanced economies lagged behind GDP growth when recovery started. Deprived of productive investment options, funds searched for yield in other less known and less productive markets. Real estate-related assets – both real and financial – were ultimately the recipient of a major portion of those financial resources. Overly fierce competition for yield brought about increasing risk assumption and, ultimately, risk undervaluation, against a backdrop of market complacency and poor transparency. Policymakers also played a role and, with hindsight, it is difficult to argue that they could not have done better. Central bankers and financial regulators have been the main targets of the criticism. The former, because they may have kept interest rates too low for too long, ignoring the negative effects of their policies on financial stability. The latter, because they failed to see the limits and the dangers of relying on market self-regulation. Prudential supervisors have also been accused of behaving in an excessively micro-oriented way, ignoring the aggregated macro-dimension of bank behaviour. To be fair, their mandates were micro-oriented and it is not by chance that one of the already visible implications of the crisis for economic policy has
been the creation of incipient macroprudential authorities such as the Financial Stability Board or the European Systemic Risk Board.\(^3\)

Europe and in particular the euro area were no exception to these general trends. But the launch of the single currency in 1999 was a genuine idiosyncratic event that deserves careful consideration.\(^4\)

In a monetary union such as EMU the interest rate and the exchange rate cease to be economic policy tools available to stabilise member countries’ domestic economies. Mundell (1961) explained the theoretical conditions for a monetary union to work, i.e. the features of the so-called Optimum Currency Area (OCA). Not surprisingly, he concluded that either the economies that link together in a monetary union should be “equal enough” (i.e. they share rather similar economic structures and are exposed to roughly the same kinds of shocks) or the area should count on a number shock absorbers powerful enough to offset the effects of (asymmetric) symmetric shocks to (even) uneven economies. Labour mobility and a soft form of shared fiscal policy rank high in the list of those potential shock absorbers. Interestingly, highly integrated financial markets may also contribute to making a monetary union an OCA, although this possibility has received much less attention in a branch of the literature that has focused mainly on the real side of the economies (for a valuable exception, see Ventura (2009)).

It is not easy to measure the contribution of the single currency to the degree of integration of financial markets in Europe. As commented before, the euro was launched at a time when many other relevant changes were taking place, so it is difficult to disentangle its genuine effects. At any rate, a single currency clearly reduces transaction costs, increases market liquidity and depth, and eliminates exchange rate risk for its members.\(^5\) It is also true that the options to diversify portfolios through the currency composition of the assets are fewer, but the available set of exchange rates was still wide enough after 1999.

In March 2007, the ECB released its first annual report on financial integration in Europe (ECB (2007)). From 1999 and before the crisis erupted in 2007, financial market integration proceeded at different speeds in the different segments of the European markets but showed a clear positive trend. Broadly speaking, the closer the market segment was to the single monetary policy, the more advanced the financial integration process. Thus, the unsecured money market quickly moved towards a fully integrated one in the euro area. The repo market had also by then attained a very high degree of integration. Government and corporate bond markets ranked next in the list, and integration had also reached a sound level in the equity markets. On the contrary, retail banking markets were much

\(^3\) For a before-the-crisis defense of macroprudential supervision see Borio (2003).

\(^4\) See Chapter 1 of this volume on global and European monetary arrangements.

\(^5\) See Chapter 6 of this volume on financial market integration.
less integrated, which was not a minor issue given the crucial role that banks played – and still play – in financing not only European households but also most European non-financial corporations, including SMEs. Figure 12.1 offers some relevant indicators that illustrate all these developments.

The euro was not the only driving force that fostered financial market integration in EMU. Progress in information and communication technologies, for instance, is likely to have played an important role as well. Yet Lane (1999) and Kalemli-Ozcan et al. (1999) showed that the euro actually made a genuine contribution to financial integration in Europe. Interestingly, they show as well how higher financial market integration contributed to making EMU an OCA through enhanced risk-sharing mechanisms that allowed for more income and consumption smoothing within the euro area.

While the positive effects of the euro on the European financial markets were quite clear and commonly accepted before the crisis, the potential risks inherent in a monetary union with a single monetary policy but multiple national governments and multiple domestic regulators and prudential supervisors received much
less attention. In June 2007, for instance, the ECB showed “greater concern that some asset price valuations could prove vulnerable to several potential adverse disturbances” (ECB (2007)). Among those potential adverse disturbances, three were highlighted. First, the ECB warned against the risk of an abrupt decline in financial market liquidity, possibly triggered by a risk reassessment. Second, it was worried about the consequences of corporate releveraging based on business models which, like the infamous “originate to distribute”, could have weakened the incentives for assessing credit risks. And the third source of risk identified was an abrupt unwinding of the so-called global imbalances. Of course, these were actual risks at the time and subsequent events validated the ECB’s fears. The ECB’s views, on the other hand, were well in line with those of many other relevant supranational institutions or international analysts (see, for instance, IMF 2007). But what is worth noting at this point is that all these risks were global, they were not – or not only – European. They affected global financial markets. European financial markets were not different and the euro hardly made any difference in that regard. Just to highlight the contrast it is worth quoting the first paragraph of the executive summary of the October 2012 IMF Global Financial Stability Report: “Downside risks to financial stability have increased since the April 2012 GFSR […] the euro area crisis remains the principal source of concern. Tail risk perceptions surrounding currency redenomination continue to fuel a retrenchment of private financial exposures to the euro area periphery”.

12.4. THE UNFOLDING OF THE CRISIS IN THE EURO AREA

Since 2005, the delinquency ratios of the so-called subprime mortgages in the US had been increasing. By the first quarter of 2008, they had jumped from levels around 6% to more than 24%.6 This was a market worth USD 1.2 trillion, roughly 12% of the US residential mortgage market at the time (see Frame et al. (2008)). However, its actual traction on the global financial markets was much higher. First, because of a number of financial innovations based on securitisation and re-securitisation techniques – which in some cases were mainly aimed at circumventing regulatory prescriptions – that had a powerful multiplier effect. Second, because as a result of the erosion of the subprime mortgage market, credit rating agencies (CRAs) decided to review their methodology to rate a wide variety of asset-backed securities including, but not limited to, those backed by pools of subprime mortgages. As a matter of fact, CRAs have received a lot of criticism for assigning, first, excessively high ratings to relatively risky assets and, then, for overreacting in their downgrading decisions when the crisis erupted. While the pro-cyclicality of credit rating agencies had been well documented in the

---

6 In the case of adjustable rate mortgages.
literature (see, for instance, Nickell et al. (2000)), in a recent paper Hau et al. (2012) suggest that rating agencies have also tended to assign more positive ratings to large banks and to those institutions more likely to provide them with additional securities-rating business.

Downgradings, foreclosures and bank losses combined and had a huge negative confidence effect on international investors. In a sense, the collapse of this small segment of the US financial markets was a wake-up call for most international investors, who were thus reminded of the basic principle in finance that expected returns and assumed risks always move in the same direction. Their reaction, a massive and uncoordinated exit from ABS and other markets, ultimately materialised in the liquidity risks that the ECB – see above – had identified.

When liquidity tensions reached the money markets – a pivotal component of the monetary policy transmission mechanism – central banks acted resolutely. Across the board, their reaction was rather similar (see Ayuso and Malo de Molina (2011)). In EMU, the ECB activated a generous liquidity provision policy by raising, first, the number of liquidity-providing operations and by increasing, later, the volume of funds injected into the system. At the same time, the average maturity of these operations was extended by increasing both the relative weight of the so-called Long-Term Refinancing Operations and their maximum horizon (from 3 to 6 months). Also, the ECB and the FED – and other central banks – activated currency swap lines to deal with liquidity problems in foreign currencies within their respective jurisdictions. It is worth noting the liquidity-oriented nature of all these measures. At that stage, the monetary policy stance was not altered either in Europe or in the USA.

Problems turned to the worst in the autumn of 2008 when Lehman Brothers filed for bankruptcy. As explained in Zingales (2008), extremely high leverage and strong reliance on short-term debt financing were decisive in explaining Lehman’s demise. It is also worth remembering that, at the time, there was a lively, open debate about the appropriate balance that had to be struck between preventing systemic risks and avoiding moral hazard problems. With hindsight, too much consideration was paid to the latter, while the systemic consequences of relatively limited shocks – which, however, were to impinge on a highly fragile global financial system – were underestimated. Be that as it may, Lehman’s fall seriously eroded the view that some institutions were too big or too systematic to fail, and prompted a further episode of retrenchment in the financial markets. This time, the expansion wave reached the real economy and fuelled a global recession that fed back into financial tensions.

The second stage of the “financial crisis – recession – fiscal crisis” sequence identified by Reinhart and Rogoff had started, and this time the impact on Europe was particularly severe. The deep-rooted reasons why the impact of the second
wave ultimately proved particularly hard in the euro area have to be sought out in the realm of EMU governance. Macroeconomic imbalances had accumulated in several countries before the crisis, putting their domestic financial systems in a vulnerable position. High financial integration linked all those vulnerabilities together, thus acting as an amplifier for any individual shock. But no efficient mechanism was available to stop the build-up of imbalances and shock contagion. Nor was any mechanism in place to deal with a crisis in a Member State that could spread to other members and ultimately undermine the soundness of the euro itself.

It is a well-known fact that the interest rate level that was appropriate for the EMU in 1999 and in the following years was too low for some of its founding members. Too-low interest rates boosted domestic demand and fed price pressures in those countries (see Figure 12.2). Domestic policymakers did not make use of the supply or demand policies still in their hands to offset such pressures (see, for instance, some relevant fiscal variables in Figure 12.3, although a similar picture could be obtained by looking at supply structural policies). With nominal exchange rates fully fixed, prices pressures translated into competitiveness losses (see Figure 12.4). As is explained in the next section, the institutional set-up of EMU was not well-equipped to prevent that accumulation of vulnerabilities and the tools available were not used in the most efficient way.

Figure 12.2: Inflation
At that point, financial markets could have played a stabilising role. Higher risk premia on bonds could have been required of governments in countries where imbalances were accumulating. Their banks, the main financial intermediaries in the euro area, could have found greater difficulty in raising the financial resources needed to finance growing current account deficits that mainly reflected competitiveness losses. Rather, the elimination of the exchange rate risk and the growing integration of the financial markets in Europe brought about by the euro greased...
those international financial flows in a context where, as commented, risks were globally underpriced. As a matter of fact, some financial systems grew in excess and accumulated serious latent risks as later developments have shown. Actually, Europe cannot be considered an exception in this regard – think, for instance of the USA. Yet the single currency added an extra gear to the process that was not accompanied by any reform aimed at empowering the capacity of the system to apply the brakes.

For readers interested in an exhaustive description of the events that followed the fall of Lehman Brothers, there are many timelines of the crisis available (for instance, the ECB, the St. Louis Fed, the University of Pennsylvania and several others such as The Guardian produce their own timelines, the reader may also find a timeline going back to the 1960s on one of the last pages in the present volume). In what follows we simply highlight those events that help us to depict the global picture.

The valuation write-downs on credit securities and the retrenchment of activity in global financial markets that followed the eruption of the subprime crisis in 2007 had an important effect on European banks, mainly on those more oriented towards investment activities. But overall, they proved quite resilient to, so to speak, the first wave of the crisis. Previous profitability performance (according to the ECB, the largest and most complex banks in the euro area posted a median ROE over 20% in the first half of 2007) and sound capital positions (their median solvency ratios stood at 11%) are the most plausible explanation for this resilience. Only some German banks that had invested heavily in real estate-related structured financial products needed to be recapitalised. Outside the euro area, the emergency loan to Northern Rock was probably the most outstanding development.

The picture changed when the second wave of the financial crisis reached Europe. As the too-big-/too-systemic-to-fail paradigm weakened and GDP growth turned into recession, uncertainty over the actual liquidity and solvency position of many banks led to a severe loss of confidence that blocked wholesale funding markets and nearly stalled unsecured money markets (see Figure 12.5). It is worth remembering that the complexity of many of the new structured financial products made it extremely difficult to figure out who was actually exposed to what.

In September 2008, two big Euro area banks (the Benelux Fortis and the French-Belgian-Luxembourg Dexia) had to be rescued. In the following months, a relatively long list of banks needed public capital injections, including also big European or domestic players in Germany (like Commerzbank), France (its six largest banks), The Netherlands (ING), Austria (Kommunalkredit), Belgium (KBC), Portugal (BPN) and Ireland (Anglo). Greek banks joined the list later on.
Some Spanish savings banks followed. In the rest of Europe, the difficulties reached the UK (RBS, for instance), Sweden and Iceland.

Policymakers in advanced economies in general, and in Europe in particular, proved to have learnt the lessons of the Great Depression, reacting quickly and decisively when world activity went into recession and financial stability tensions surged. In addition to fiscal stimulus programmes, their partially coordinated actions also included measures in the financial arena. More specifically, in October 2008 the Heads of Government or State of the European Union agreed to extend the coverage of deposit guarantee schemes to enhance depositors’ confidence and to prevent bank runs that would have been extremely dangerous. Also, to alleviate the funding problems linked to the closure of wholesale funding markets, governments put in place a policy of government guarantees for fresh bank bond issuance. And to underpin the solvency of some particularly hard-hit banks, fresh public capital was injected into a number of institutions. Various programmes for asset purchases or swaps were also arranged and, later on, coordinated stress test exercises were performed to increase transparency and to reduce investors’ uncertainty over the actual situation of the most systemic banks. Asset Protection Schemes and the set-up of the so-called bad banks (like NAMA in Ireland or SAREB in Spain) have also been among the tools wielded.

---

“Bad bank” is, however, an unfortunate label as, first, in most cases the institution set up is not a bank but a non-financial real asset management company. And second, because as the Swedish experience in the late 1990s shows, the institution does not necessarily have to be unprofitable. See Chapter 11 of this volume on shadow banking and off-balance sheet business.
Along these lines, the European Central Bank also made a significant contribution to the broad effort to restore normality. From a macroeconomic perspective, the ECB joined many other central banks in providing a monetary stimulus through aggressive interest rate cuts (see Figure 12.6 – official rates in UK, USA and euro area). Action via the standard arm of monetary policy was complemented with a wide set of non-standard measures aimed, first, at filling the gap that the collapse of the unsecured money markets had created in the distribution of liquidity among European banks. Thus, in October 2008 the ECB decided to provide their counterparties all the liquidity they demanded in its regular open market operations and also fine-tuned its collateral policy to prevent a collateral shortage from potentially creating a bottleneck in liquidity distribution. All in all, the ECB fully took over the role of the non-operational interbank market as liquidity distributor among banks.

Figure 12.6: Official Interest Rates

At the same time, the crisis also impaired the monetary policy transmission mechanism, thus preventing monetary impulses from symmetrically reaching all households and firms across the euro area. This also required action, as keeping the different transmission channels operational fully falls under the central bank remit. The so-called Covered Bond Purchase Programme(s) and the Securities Market Programme (see ECB 2011) are surely the most outstanding examples of the ECB’s interventions to repair very relevant links of the chain connecting the MRO rate to the interest rates that determine expenditure and investment decisions by both the private and the public sector. More recently, the approval of the so-called Outright Monetary Transactions has also been instrumental in dispelling mounting doubts over the irreversibility of the euro.
In this regard, it is worth noting that the high degree of financial integration within EMU propelled by the euro before the crisis helped ease shock propagation and contagion when the crisis erupted. There were no circuit breakers able to stop them. Nor, as the crisis unfolded, were there any mechanisms to prevent financial integration from being reversed (see, for instance, ECB (2013)) to the extent that the re-nationalisation of financial flows exerted some extra pressure on those domestic financial systems that were in a more vulnerable position. Again, the governance of the euro proved poorly designed to deal with the crisis.

Finally, government guarantees and public capital injections initially acted as powerful shock-absorbers in Europe. But as a result, public finances were closely tied to the situation of banking systems. The Irish government’s decision to implement blanket guarantees for most of their bank liabilities offers an extreme example of this connection. Feedback mechanisms between financial and fiscal risks were activated, thus completing a perverse triangle with financial, fiscal and growth risks in its three vortexes. The feedback between growth and fiscal risks (through the role of the so-called automatic stabilisers), along with that between growth and the soundness of banks (more non-performing loans that cause losses and prevent further loans to finance growth), was already well-known.

Of course, dealing with this triangle is a challenge for any country. Three euro area countries, Greece, Ireland and Portugal, had to ask for financial support as their governments lost market access. Within a monetary union and, in particular, within the euro area, the challenge becomes harder as a result of the unique combination of a single monetary policymaker but many little-coordinated national fiscal and financial policymakers. The nature of the problem can be briefly described as follows: any fiscal or financial measure taken at the national level within a financially integrated monetary union is very likely to have strong effects on the rest of the member states. Without a very well-designed framework for such a decision-making process it is very difficult for all the externalities, be they positive or negative, to be properly taken into account at the national level. It is precisely here where the uniqueness of the crisis in the euro area lies: in the absence of well-defined, comprehensive institutional arrangements for economic policymaking in EMU, some saw in the crisis an earthquake with the potential to break up the monetary union. This source of risk is quite idiosyncratic.

Explaining in detail the weaknesses of the framework designed for the euro in 1999, the steps taken to repair the cracks identified and the challenges ahead are the focus of the following sections of this chapter. To motivate them and to conclude this section, Figure 12.7 plots the course of a standard financial tension indicator (the 10-year sovereign yield spread to Germany) around the main events and decisions made in the realm of euro area governance during the crisis. It can be seen that after some of these events the indicator changed significantly. For
example, after the announcement of the OMTs, the indicator fell remarkably for all countries included in the Figure. The reaction of the markets after these events illustrates the important role played by the euro area economic governance during the crisis.

Figure 12.7: 10-year Sovereign Yield Spreads to Germany

12.5. **The Main Weaknesses of the Euro Area Institutional Framework that Fed the Crisis**

Unlike monetary policy, the other macroeconomic policies and financial policies continued to be in the hands of national governments. To ensure some minimum degree of convergence between economies, convergence criteria were defined which had to be satisfied by member states before they were admitted to the third stage of monetary union. These included threshold levels for variables such as inflation rates, fiscal deficit, debt levels and interest rates. However, there was no mechanism in place to foster a deeper convergence of the economies after admission.

The Maastricht Treaty (hereafter the Treaty) also included various provisions to ensure some coordination of economic policies. In particular, the Treaty granted power to the European Commission and the Economic and Financial Affairs Council (ECOFIN) to monitor deficit and debt levels and to issue warnings and impose fines if necessary.

Special emphasis was placed on the need to maintain fiscal discipline to avoid spillover effects. The main mechanism to strengthen fiscal discipline was the
Stability and Growth Pact (SGP), introduced in 1997 as a Council regulation. Under the SGP, member states had to fulfill two main criteria: i) an annual fiscal deficit not exceeding 3% of GDP, and ii) government debt not exceeding 60% of GDP, or diminishing and approaching that level. The SGP had two components: a preventive arm and a corrective arm. The preventive arm included two instruments. First, it required countries to achieve medium-term objectives. In particular, countries were urged to achieve a close-to-balance or fiscal surplus position, setting a maximum fiscal deficit of 0.5% of GDP over the cycle. Second, the ECOFIN could issue an early warning to prevent the occurrence of an excessive deficit. To comply with this arm, euro area member states were required to submit annual stability programs to the EC and the ECOFIN, showing how they planned to achieve or safeguard sound fiscal positions to meet the so-called medium-term budgetary objectives (MTOs). The EC then assessed these programmes and ECOFIN gave an opinion on them and made recommendations.

The corrective arm governed the Excessive Deficit Procedure created by the Treaty. In particular, it specified triggers for this procedure and, if it was decided the deficit was excessive, the ECOFIN issued recommendations to the member state concerned, providing guidance and a timeline to correct it. If the ECOFIN believed that the member state failed to comply with the recommendations, it was allowed to demand a non-interest bearing deposit with the EU or impose a fine on the member state.

But the SGP did not work in practice as a fiscal discipline mechanism. The lack of consensus between the EC and the Council on the need to apply fines to France and Germany in connection with the non-fulfillment of their commitments led to a reform of the SGP in 2005, which basically introduced more flexibility into its implementation. The most important changes included revised medium-term objectives accounting for national differences, as well as clarification of “exceptional and temporary” excesses and “other relevant factors”. This greater flexibility allowed countries to use fiscal policy to counteract the impact of the crisis. As a result, many countries exceeded the reference values for the fiscal deficit and debt, and this did not lead to the fines stipulated in the SGP, rendering this instrument barely effective as a mechanism to strengthen fiscal discipline. For example, Darvas (2010) found that between 2001 and 2006 approximately one-third of euro area member states violated the SGP, and this did not lead to any sanction being levied.

In the area of structural and macroeconomic policies an even more lenient scheme was introduced. The main instrument of coordination was the so-called Broad Economic Policy Guidelines. These established the economic policy priorities for the euro area. The surveillance of fulfillment was based on the exchange of experiences and information between countries, and on peer pressure. But, as noted
by Pisani-Ferry (2010), these guidelines have consistently been ignored by national policymakers and the possibility of issuing a recommendation was used only once, without any effect.

The less rigid scheme in this area reflected the idea that the existence of the monetary union would per se foster a reform process as a consequence of the increase in competition among member states. Also, in contrast to the situation in the area of fiscal policies, the empirical evidence suggested that the spillover effects associated with structural reforms were limited [see, for example Evaert and Schule (2006)].

These coordination schemes in the area of structural and macroeconomic policies were not effective in fostering far-reaching structural reforms and did not prevent the build-up of large macroeconomic imbalances and competitiveness divergences within the euro area.

In the financial sector, policies also continued to be in the hands of national authorities. Although there was some degree of harmonisation of regulation, it was far from sufficient for the needs of a single financial market, as stressed for instance by the so called de Larosière Report (2009). According to that Report, the regulatory framework in Europe lacked cohesiveness as a result of the options provided to EU members in the enforcement of common directives. These options led to a wide diversity of national transpositions related to local traditions, legislation and practices. The Report also stressed that the diversity of regulations complicated the management of crises in the event of cross-border institutions, as the experience with Fortis and Dexia has shown.

The supervision of financial institutions was also in the hands of national authorities, and the institutions in charge of deposit insurance and bank resolution were also nationally based. This contributed to increasing the feedback loops between the sovereign and the banking sector in countries more affected by the crisis, as the deteriorating solvency of the banking sector increased the contingent liabilities of the public sector.

The recent crisis has also shown the lack of adequate macro-prudential supervision, although this weakness was not exclusive to the euro area. In particular, supervision placed too much emphasis on the oversight of individual institutions without taking into account systemic risks. Although some macro-prudential risks were identified by some public institutions such as the ECB and the IMF, there was no mechanism to ensure that this assessment translated into action.

Finally, the euro area lacked crisis-management institutions to stop destabilising market dynamics during stress periods. Although in other monetary unions, such as the United States, there are no crisis-resolution mechanisms for sub-central governments either, there are two important differences between the US and the
First, national government debt in the euro area is comparatively higher than sub-central government debt in the US. Second, in the euro area a substantial proportion of national government debt is in the hands of national banks. This means that a government default in the euro area could have an additional dimension which is not present in the case of sub-central government debt in the US due to the role played by banks as financial intermediaries.

As De Grauwe (2011) stresses, in a monetary union the ability of countries to stop destabilising market dynamics is limited since the lack of monetary sovereignty means that the national central bank cannot intervene in the markets to counteract speculative attacks against its public debt. In particular, in a member of the euro area the government debt is issued in euro, a currency which is not under the control of national authorities, and markets could potentially provoke a liquidity crisis if they shifted their portfolio to other euro-denominated assets. As De Grauwe argues, an event like this is similar to what happens to emerging economies that finance themselves in foreign currency, which could at some point face sudden stops in external funding that might eventually lead to a liquidity crisis, even in cases in which there are no solvency problems. If not checked, such dynamics could result in self-fulfilling expectations and force a default of the country in question. To prevent this scenario the international financial architecture has provided various instruments in the form of precautionary funding as mechanisms designed to stop financial instability episodes. But in the euro area this type of mechanism did not exist. During the current sovereign debt crisis, markets have identified the existence of this flaw in the institutional architecture of the euro area and various waves of financial instability have occurred in which markets have speculated against the countries perceived as being more vulnerable.

12.6. Progress Made So Far

A special Working Group made up of the finance ministers of EU countries, the EC and the ECB, led by Herman Van Rompuy, president of the European Council, was launched in 2010. Its aim was to propose a reform of economic governance without modifying the key aspects of the Maastricht Treaty in order to avoid an overly long and costly process. The final report of this Group was released in October 2010. Most of its recommendations have already been introduced.
In the area of fiscal policy, a reform of the SGP came into force at the end of 2011. Table 12.1 summarises the main changes introduced. The reform establishes new rules and a more effective enforcement with the aim of reinforcing the budgetary discipline of Member States. The new rules give more importance to the debt criterion of the Treaty, which was largely neglected before the reform, in both the preventive arm and the corrective arm. In the latter case, Member States can be subjected to the excessive deficit procedure if the 60% reference level for the debt-to-GDP ratio is exceeded even if their deficit is below 3%. In the preventive arm, a new expenditure benchmark is defined to help assess progress towards MTOs. This new benchmark places a cap on the annual growth of public expenditure, expressed as a medium-term rate of growth. For Member States that have not yet reached their MTO, the rate of growth of expenditure should be below this reference rate in order to ensure adequate progress. To make the enforcement of rules stricter, the so-called reverse qualified majority voting procedure was introduced for the application of sanctions. Under this new procedure, the Council can impose a financial sanction on Member States that do not fulfil their obligations on the basis of a recommendation by the EC, unless a qualified majority of Member States votes against it. Previously, a qualified majority voting system applied, meaning that to impose a sanction a qualified majority of countries had

---

Table 12.1: The Main Changes Introduced in the Stability and Growth Pact (SGP)

<table>
<thead>
<tr>
<th>PREVENTIVE ARM</th>
<th>CORRECTIVE ARM</th>
<th>ENFORCEMENT STRUCTURE</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Annual growth of public spending should not exceed medium-term GDP growth or should be clearly lower in the medium-term objectives (MTOs) have not been achieved.</td>
<td>• If the public debt/GDP ratio is higher than 60%, it must decrease over the course of the three years prior to the assessment - by one-twentieth with respect to the amount by which it differs from the reference value in order to avoid the initiation of an Excessive Deficit Procedure (EDP).</td>
<td>• New political and reputation sanctions</td>
</tr>
<tr>
<td>• Public spending growth may exceed medium-term GDP growth in the MTOs have been comfortably achieved or if the surplus spending is offset with discretionary increase in revenue.</td>
<td>• In order to determine whether or not to initiate an EDP, in addition to the numerical benchmark, other important factors will be considered: implicit liabilities related to the level of private debt, the ageing of the population and the net cost of implementing the pension reform.</td>
<td>• New financial sanctions: non-interest earning deposit amounting to 0.2% of GDP under the corrective arm</td>
</tr>
<tr>
<td>• Possibility of applying sanctions if a country does not achieve the MTOs and there are significant deviations from public spending growth.</td>
<td>• A more rapid adjustment path is proposed, which has not yet been quantified, for countries with debt of more than 60% or with high risks in terms of debt sustainability.</td>
<td>• Greater automaticity with the introduction of reverse voting procedures in the decision-making process</td>
</tr>
</tbody>
</table>

---

8 The new measures, the so-called “Six-Pack”, are made of five regulations and one directive proposed by the EC and approved by all 27 Member States and the European Parliament. These measures entered into force on 13 December 2011.
to vote for it. This new system is more automatic and gives more power to the EC. Also, new sanctions have been introduced. In particular, in the preventive arm, an interest bearing deposit of 0.2% of GDP can be imposed. In the corrective arm, a non-interest bearing deposit of 0.2% of GDP can be imposed. Failure to comply with recommendations for corrective actions can result in a fine.

Minimum requirements for national budgetary frameworks were also introduced. These requirements, which cover all administrative levels, establish that fiscal frameworks should be in line with minimum quality standards. National fiscal planning should adopt a pluri-annual perspective, so as to attain the MTOs. Numerical fiscal rules should also promote compliance with the Treaty reference values for deficit and debt.

More recently, the so called fiscal compact, which was included in the Treaty on Stability, Coordination and Governance\textsuperscript{9}, further strengthened fiscal surveillance. In particular, the threshold for the fiscal deficit included in the definition of the balanced-budget objective to be applied in the MTOs was reduced from 1% to 0.5% of GDP. Also, to reinforce this objective, it requires a rule to be introduced in national legislation that is binding, as a constitutional rule would be. Finally, the fiscal compact further strengthens the role of the EC vis-à-vis the Council, as it states that all EC proposals and recommendations may be considered as automatically applied unless the Council rejects them by qualified majority.

In the area of macroeconomic policy, a new surveillance and enforcement mechanism has been introduced with the aim of preventing and correcting macroeconomic imbalances. The mechanism, called Macroeconomic Imbalance Procedure (MIP)\textsuperscript{10}, has some similarities with the SGP. Like the SGP, it has a preventive arm and a corrective arm. An early warning system is established based on a scoreboard consisting of a set of indicators covering the major sources of macroeconomic imbalances. For each indicator, alert thresholds have been set to detect potential imbalances. Table 12.2 shows the current set of indicators used and their thresholds. The scoreboard and the thresholds are not applied mechanically. The scoreboard is complemented by an economic reading of indicators, taking into account additional indicators. The aim of the scoreboard is to trigger in-depth analysis in order to determine whether the potential imbalances are problematic or not. The MIP allows the EC and the Council to adopt preventive recommendations at an early stage before imbalances became large. In more serious cases an excessive imbalance procedure (EIP) can be opened for a Member State. In these cases, the Member State concerned will have to submit a corrective

\textsuperscript{9} The Treaty on Stability, Coordination and Governance is an inter-governmental treaty, signed by 25 of the 27 EU Member States. In the early 2013, the treaty is in the process of ratification by the national parliaments and may be subject to referendum in some Member States.

\textsuperscript{10} The MIP is based on Article 121.6 of the Maastricht Treaty.
action plan with a clear roadmap and timeline for implementing the corrective action. An enforcement regime similar to the one applied to the SGP is introduced for the MIP. In particular, an interest-bearing deposit can be imposed after one failure to comply with the recommended corrective action. After a second compliance failure, this deposit can be converted into a fine of up to 0.1% of GDP. The reverse qualified majority voting system is also applied here. The MIP started to be implemented in 2012. In the first alert mechanism report under the MIP, as of February 2012, 12 Member States warranted in-depth reviews. In the second round, in November 2012, 13 Member States were in this situation.

Another new instrument introduced with the aim of coordinating fiscal and structural policies is the so-called European Semester. It is a yearly exercise encompassing all new instruments, including the MIP.

In the financial sector, significant changes have also been introduced over the recent period. In November 2008, the EC mandated a High Level Group chaired by Jacques de Larosière to propose recommendations on how to strengthen the European supervisory and regulatory framework to better equip it to promote financial stability. The final report was presented on February 2009. The propos-

Table 12.2: Scorecard Indicators in the Macroeconomic Imbalance Procedure (MIP)

<table>
<thead>
<tr>
<th>VARIABLE</th>
<th>THRESHOLD</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 years backward moving average of the current account balance as percent of GDP</td>
<td>&gt; 6% GDP</td>
</tr>
<tr>
<td></td>
<td>&lt; -4% GDP</td>
</tr>
<tr>
<td>Net international investment position as percent of GDP</td>
<td>&lt; -35% GDP</td>
</tr>
<tr>
<td>5 years percentage change of export market shares measured in values</td>
<td>&lt; -6% GDP</td>
</tr>
<tr>
<td>3 years percentage change in nominal unit labour cost</td>
<td>&gt; 9% euro-area countries</td>
</tr>
<tr>
<td></td>
<td>&gt; 12% non-euro-area countries</td>
</tr>
<tr>
<td>3 years percentage change of the real effective exchange rates based on HICP/CPI deflactors, relative to 35 other industrial countries</td>
<td>&gt; 5% euro-area countries</td>
</tr>
<tr>
<td></td>
<td>&lt; -5% euro-area countries</td>
</tr>
<tr>
<td></td>
<td>&gt; 11% non-euro-area countries</td>
</tr>
<tr>
<td></td>
<td>&lt; -11% non-euro-area countries</td>
</tr>
<tr>
<td>Private sector debt in % of GDP</td>
<td>&gt; 160%</td>
</tr>
<tr>
<td>Private sector credit flow in % of GDP</td>
<td>&gt; 15%</td>
</tr>
<tr>
<td>Year-on-year changes in house prices relative to a Eurostat consumption deflactor</td>
<td>&gt; 6%</td>
</tr>
<tr>
<td>General government sector debt in % of GDP</td>
<td>&gt; 60%</td>
</tr>
<tr>
<td>3 year backward moving average of unemployment rate</td>
<td>&gt; 10%</td>
</tr>
<tr>
<td>Year-on-year changes in total financial sector liabilities</td>
<td>&gt; 16.5%</td>
</tr>
</tbody>
</table>

LARCIER
als focused on strengthening cooperation and coordination between national supervisors, including through the creation of new European Supervisory Authorities and a European-level body in charge of macroprudential supervision. Building on these recommendations, a regulatory and supervisory reform has been implemented in recent years. In particular, the new European financial supervisory framework is composed of two new pillars. The first pillar is the European System of Financial Supervisors (ESFS) consisting of a network of national financial supervisors working in tandem with new European supervisory authorities for microprudential supervision purposes (i.e. to safeguard financial soundness at the level of individual financial institutions and protect consumers of financial services). The second pillar is the European Systemic Risk Board (ESRB), a new body whose main task is macroprudential supervision, i.e. monitoring and assessing potential threats to financial stability that arise from developments within the financial system as a whole. To this end, the ESRB can issue warnings and recommendations for action to Member States. This new body addresses one of the weaknesses identified during the crisis, namely the lack of oversight of systemic risks.

More recently, in December 2012, the Council agreed on the main features and the implementation timetable of the so-called Single Supervisory Mechanism (SSM). This new mechanism will be made up of national supervisory authorities and the ECB, which will be in charge of the prudential supervision of all euro area credit institutions whose assets exceed a certain threshold level and also those receiving financial assistance. National supervisors would remain in charge of tasks not conferred on the ECB, for instance in relation to consumer protection, money laundering, payment services, and branches of third-country banks. Non-euro area countries wishing to participate in the SSM will be able to do so by entering into close cooperation arrangements. The EBA (one of the new European supervisory authorities set up in 2011) will be responsible for developing a single rule book and for ensuring the convergence and consistency of supervisory practices among European countries. To comply with the new function and achieve a strict separation between monetary policy tasks and prudential supervision, the ECB will introduce a new supervisory board. Decisions will be deemed approved unless rejected by the Governing Council of the ECB. According to plans, the ECB will start with its new function 12 months after the entry into force of the relevant legislation.

Finally, in the area of crisis resolution, during the euro area sovereign debt crisis the lack of established mechanisms was initially addressed through some temporary arrangements including bilateral lending from euro area partners, in partnership with the IMF, to Greece in May 2010 and the set-up of two temporary financing mechanisms – the European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM) – with a combined firepower of
EUR 500 billion. Ireland and Portugal were granted financial assistance from these funds, and also Greece in a second programme, with the IMF co-funding in each case. The scope of these facilities was widened to fund programmes related to the banking sector and to purchase government bonds on the secondary markets. The aim of these programmes was to preserve the financial stability of the EU by providing financial assistance to Member States in difficulty.

In October 2012, a new permanent safety-net mechanism, the so-called European Stability Mechanism (ESM), came into force. Its main features build on the EFSF. The ESM was set up by treaty as an intergovernmental organisation under public international law\(^\text{11}\). It will be the primary support mechanism of the euro area Member States. Unlike the EFSF, which was based upon euro area Member State guarantees, the ESM will have subscribed capital of EUR 700 billion provided by Member States, of which EUR 80 billion will be in the form of paid-in capital and the remaining EUR 620 billion will be callable capital. This capital will provide a lending capacity of EUR 500 billion. Financial assistance programmes to Member States will be funded through the issuance of debt securities on the financial markets. This assistance will be activated upon a request from a Member State to the ESM and will be provided subject to conditionality. The conditionality will be detailed in a Memorandum of Understanding that Member States asking for assistance negotiate with the EC, in liaison with the ECB. The initial instruments available are the same as those available for the EFSF. In particular, the ESM can provide loans to a euro area Member State in financial difficulties, intervene in primary and secondary debt markets, act on the basis of a precautionary programme and provide loans to governments for the purpose of recapitalisation of financial institutions. ESM assistance was first used in the recapitalisation programme of Spanish banks at the end of 2012.

12.7. The Challenges Ahead

The intensification of financial market tensions in mid-2012 showed that a key element of the crisis was the feedback loop between sovereign risk and banking risk, along with the increasing fragmentation of financial markets. The reforms in the economic governance of the euro area undertaken up to then were not sufficient to break these feedback effects and the fragmentation trend in financial markets. Against this background, in June 2012 the Heads of State or Government of the participating Member States discussed the report “Towards a genuine economic and monetary union”, prepared by the president of the European

---

\(^{11}\) The Treaty Establishing the European Stability Mechanism was signed on 2 February 2012. The ESM was inaugurated on 8 October 2012 upon completion of the ratification process by participating euro area Member States.
The European Council, in cooperation with the presidents of the EC, Eurogroup and the ECB. The report sets out “four essential building blocks” for the future EMU: an integrated financial framework (banking union), an integrated budgetary framework (fiscal union), an integrated economic policy framework (economic union) and strengthened democratic legitimacy and accountability (political union). In that meeting, the president of the European Council was invited to develop a specific and time-bound road map for the achievement of a genuine economic and monetary union.

Among the four areas identified as deserving further integration, banking union was given priority. A banking union has three elements: supervision, a resolution mechanism and a deposit guarantee mechanism. In December 2012, it was agreed to start the implementation of the SSM. The SSM is a major step towards a banking union, but other more fundamental elements such as a single resolution mechanism and a single deposit insurance mechanism are still pending. These two elements are essential for completing the banking union, for breaking the feedback channels between banking and sovereign risks and for fostering financial integration. As regards bank resolution, it is essential that the responsibility is moved to the European level. As stressed by the EC in the report “A blueprint for a deep and genuine economic and monetary union. Launching a European debate”, this solution will be more efficient than a network of national resolution authorities, particularly as regards cross-border banking groups, and avoid the negative externalities associated with national decisions. A single deposit insurance mechanism is another important element needed to prevent deposit flight in stress periods.

In the fiscal union realm, discussions are focusing on the need to develop an insurance-type mechanism between euro area countries to buffer country-specific economic shocks. The economic rationale for this type of mechanism is the low labor market mobility in the euro area and the limited role played by the fiscal channel as a risk-sharing mechanism. Different options for a euro area fiscal capacity have been proposed (see, for example, Pisani-Ferry et al. (2013)) including unemployment insurance funded by the European budget and a payment system linked to deviations of actual GDP from potential GDP. Another element of the fiscal union would be the issuance of common debt securities. This would resolve the vulnerability of countries that issue securities in a currency not under the control of national authorities during bouts of loss of market confidence. However, the challenge is to design this new instrument in a way that does not weaken incentives to pursue sound fiscal policies as a result of moral hazard.

In relation to economic union, there is a need to put in place a stronger framework for coordination, convergence and enforcement of structural policies. To that end, the EC proposed a framework consisting of two elements: i) a mecha-
nism for systemic ex ante coordination of major reform projects of Member States in the context of the European Semester and ii) a Convergence and Competitiveness Instrument (CCI) in the framework of the MIP based on contractual arrangements between the EC and euro area Member States with the possibility of financial support. This framework should help foster structural reforms needed in the euro area to prevent the emergence of disequilibria and to strengthen adjustment channels. To further foster competition it is also important to make further progress in eliminating existing barriers to trade and to the selling of international services and to achieve a higher degree of tax harmonisation to avoid distortions to business competition.

Finally, the Report prepared by the president of the European Council in June 2012 stresses the need for strengthening democratic legitimacy and accountability. The idea is that the move towards more integrated fiscal and economic decision-making between countries requires strong mechanisms for legitimate and accountable joint decision-making. This would require the involvement of the European Parliament for decisions taken at the European level.

The reforms undertaken so far have tackled some of the weaknesses of the euro area governance, but challenges ahead are enormous (see Table 12.3). In short, the reforms in the economic governance of the euro area imply a significant change in the driving forces operating to achieve an optimum currency area (OCA). The underlying assumption when the euro was launched was that an OCA would result endogenously as a result of competition and the disciplining role played by financial markets. But experience has shown that this assumption was not realistic. Against this background, the current reforms aim at achieving an OCA by introducing externally a more integrated framework in all economic policy areas. This process will require the transfer of sovereignty from the national level to the European level.

12.8. CONCLUDING REMARKS

This chapter has shown that although the current crisis in Europe presents some common features with other financial crises, there are some idiosyncratic factors that have played a crucial role in rendering the crisis deeper and more lasting. In particular, we have stressed that the euro area governance framework did not prevent macroeconomic imbalances from building up in several countries before the crisis and putting their domestic financial systems in a vulnerable position. The high financial integration fostered by the euro amplified the shock propagation and contagion when the crisis erupted and the lack of instruments to deal with domestic crises complicated the resolution against a background in which the ability of countries to combat destabilising market dynamics was limited due
to the lack of control over the currency issued by sovereigns. The feedback loops between sovereign risks and banking risks added an extra source of complexity.

The crisis has underscored the need for a deep overhaul of the governance of the euro area. Some promising steps have been taken since the crisis erupted. In a first stage the reforms focused on strengthening budgetary surveillance, introducing a new framework for the surveillance of economic policies and setting up crisis resolution mechanisms. But these reforms were not sufficient to break the feedback loop between sovereign risk and banking risk and to curb the fragmentation trend in financial markets. Therefore, deeper reforms are needed. Against this background, a second stage of the reform was initiated last year along the lines of the report “Towards a genuine economic and monetary union”. In particular, the report proposes a move to an integrated framework in four areas: banking, economic policy, fiscal policy and democratic legitimacy and accountability. The
area of banking was given priority and the first steps to implement a single supervisory mechanism have already been initiated. This is a major achievement, but full banking union also requires single bank resolution and deposit insurance mechanisms. Progress in the other three areas identified in the report is also pending. Hence the reform is far from having been completed.

Once the reform is completed the euro area will be better equipped with mechanisms to prevent the build-up of imbalances in particular Member States and reduce their vulnerability to external shocks, and will have more efficient instruments to manage financial crises. In the meantime, a number of “legacy problems” will also have to be dealt with. The challenges ahead are enormous, but this is the only way if we Europeans want the next time to actually be different.

REFERENCES


DE LAROSiÈRE REPORT, 2009, The high-level group of financial supervision in the EU.


Lane, P., 2009, “EMU and Financial Integration” in *The Euro at Ten*, ECB.


Reinhart, C. and Rogoff, K., 2011, “From Financial Crash to Debt Crisis”,

& Oxford.

ECB.

Testimony before the Committee on Oversight and Government Reform,
United States House of Representatives.