



European
Commission

European economic governance in an international context

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José Manuel Barroso
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Anni Podimata
Dusan Sidjanski
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Androulla Vassiliou
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European Commission
Directorate-General for Education and Culture
Jean Monnet programme

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European economic governance in an international context

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Welcome speech

Jan Truszczyński

Opening remarks



Jan Truszczyński

*Director-General for Education,
Training, Culture and Youth of the
European Commission*

Excellencies, ladies and gentlemen, allow me to welcome you warmly to this 2011 Global Jean Monnet Conference. Every day now confirms the pertinence and timeliness of the topic of this year's conference: European economic governance in an international context.

The world of thought and the world of action keep moving with high intensity. We are waiting for President Van Rompuy's report to the European Council meeting in 2 weeks, and yesterday the European Commission published its Green Paper on the feasibility of introducing stability bonds. This, as we know, was preceded earlier this autumn with a new fiscal surveillance and enforcement mechanism known as the six-pack.

A few weeks ago, we saw the documents from the German CDU party pleading for the completion of economic and monetary

union. Last week, Jürgen Habermas was kind enough to contribute to the governance discussion with his new book *Zur Verfassung Europas* on Europe's constitution.

It is of course useful to recall that many of the governance arguments advanced today were formulated many years ago, as many professors here know from their own academic practice and experience. I recently read a report by Professor Iain Begg, published by the *Bertelsmann Stiftung*, which quotes from the 1970 Werner report on economic and monetary union. This report saw the harmonised management of national budgets as an essential feature of cohesion in such a union. Furthermore, the Werner report requested that the European Community should be in a position to influence the national budgets.

This morning we will have the privilege of hearing from some of the most important voices in the debate on the future of the European Union and on the future of European economic and monetary integration. First of all, we will have the honour of hearing from President Barroso, who has, this time, addressed a video message to us. It will be a follow-up of what he was saying recently, speaking about the deepening of economic governance in the European Union, and in the eurozone as a single currency area.

I.

Opening session

José Manuel Barroso
Androulla Vassiliou
Anni Podimata

European economic **governance** in an international context



José Manuel Barroso

President of the European Commission

Ladies and gentlemen, as many of you will know, the Jean Monnet programme is very close to my heart. As a young scholar, I myself participated in many European academic programmes and exchanges. I always do my very best to attend your conferences, not least because I find them as enjoyable as they are intellectually stimulating. Very sadly, today events have conspired against me and unfortunately I can only be with you through this video message. I hope to compensate my absence with some good news for you. I am pleased to tell you that yesterday the Commission adopted new proposals to reinforce the Jean Monnet programme in the next financial framework programme. This is a clear demonstration of our sincere commitment to the Jean Monnet programme.

Ladies and gentlemen, the topic we have chosen for this year's Jean Monnet global conference could not have been timelier. As we are still fighting one of the worst crises, probably the worst, since the start of European integration, and we are also fighting its consequences on the eurozone in particular, we need both firemen and architects. We need to see the urgency and respond to the urgency of the situation, but we also need to lay down foundations for a stronger euro area and European Union for the future.

The world around us is changing fast, and Europe needs to change too if it is not to be left behind. In our globalised world, more Europe, and not less Europe, is more essential than ever, so that

we can preserve our way of life, protect our values and promote the prosperity of our citizens. And I believe that more Europe is also important for the rest of the world. In the age of globalisation, the world needs a stronger Europe more than ever. Together with our Member States and the other European institutions, we have been at the forefront of developing a collective and common European response to the crisis. The reality is that there is still much to do. We need to build a strong and sustainable recovery on sound foundations. To restore confidence we need a Union of responsibility, but also of solidarity. We need banks that are able to lend and governments that are able to borrow, companies that are willing to invest and consumers who are willing to spend. We need bold reforms at a national level accompanied by enhanced cooperation and governance at the European level.

For that to happen, for this stability Union and this solidarity Union to happen, we need more discipline and also more convergence. We clearly have to focus our efforts on enhancing stability and convergence between the 17 members of the eurozone. But we have to be sure that it will be done without damaging the interests of the European Union as a whole and all its 27 Member States. There is no time to waste if we want to prevent Europe from suffering a lost decade, to get out of the crisis stronger and also more united. The reality is that the cost of deferred action has already been very high. The cost of non-action, as I've said already, is fragmentation; it could ultimately be disintegration, and this would be an unbearable cost for all of us. Therefore, it is essential to get on with implementing the important decisions already taken and to do everything we can to ensure the stability of the eurozone and the future of the European Union. This is needed, and leadership is precisely to ensure that what is needed is done. It is in this spirit that yesterday the Commission adopted further proposals to enhance our economic governance within our existing treaty framework. As Europe is at a crossroads, fresh ideas from other European actors and friends and a renewed commitment to the European project are more necessary than ever. I am sure that your conference will bring some of these ideas. I wish you very fruitful work, and I do hope I can look forward to being with you next year. I wish you every success.

Jan Truszczyński

Let me thank President Barroso for these inspiring remarks and let me now introduce our next keynote speaker, Commissioner Androulla Vassiliou, Commissioner for Education, Culture, Multilingualism, Sport, Media and Youth. In all these capacities she has the political responsibility and accountability for making policy in all of these fields at the European level, including in the field of the Jean Monnet actions. As President Barroso has just remarked, her proposals found acceptance and support yesterday at the College and were transformed into a draft legislative proposal for our Member States and for the European Parliament in the context of the Jean Monnet actions.

European economic **governance** in an international context

Thank you Jan, and good morning ladies and gentlemen, distinguished participants. In his video message, President Barroso underlined that in this crucial moment of European integration, we would need both firemen for ad hoc solutions and architects for a systemic impact. With his words, he set the scene for our conference and I am convinced that today and tomorrow proposals for immediate solutions and long-term perspectives will be made and discussed. I would also like to thank Vice-President Anni Podimata from the European Parliament. She has always shown strong commitment to the European project, and I greatly appreciate her presence here today. It is equally an honour to have among us this morning Professor Mundell. His groundbreaking work on exchange rates and currency areas has underpinned much of the reflection that led to European monetary union. We are all very eager to hear his views on the current situation. But all of you here, in this room, in your respective fields of expertise, contribute to the effort of building a stronger Europe and a more prosperous world. I would therefore like to thank you all for your participation.

I do not need to tell you that these are challenging times. We all know that the European Union is going through one of the most serious crises since its creation. The euro is a pillar of our Union. When it is threatened, our Union and its ability to move forward are also threatened. This is due to the nature of the euro project. The euro was not born as a purely political project, but also as a



Androulla Vassiliou

*Commissioner for Education, Culture,
Multilingualism, Sport, Media and Youth*

mechanism designed to realise the dreams of the European idealists. Neither was it a purely technocratic project. The creation of the euro certainly responded to an acutely felt economic necessity: that of creating monetary stability, leaving behind the financial chaos of the seventies and eighties, and putting Europe's growth trajectory on a more stable footing. It also responded to another deep-seated aspiration: the vision of an ever-closer union of the peoples of Europe. It marked a great political and economic step towards it, and was recognised as such by all.

It has remained a work in progress though; unfinished business to the extent that the politics of European economic integration lag behind the accomplishment of formal monetary union. Now, in order to find a solution to the problems that beset the euro, the economic and political sides of the equation must be rebalanced. This is the burning topic you will debate today. European economic governance: the political mechanism needed to ensure good economic progress.

Your contribution could not be more timely and more welcome. Actually in these times of economic and financial turbulence, I am convinced that the Jean Monnet programme has never been more relevant. I cannot imagine a more engaged and competent group than the Jean Monnet professors gathered here. Your sharp analysis gives us the independent critical view on European integration, which we need to hear in particular in times of crisis. In addition, the Jean Monnet network provides a much needed space for a truly trans-European reflection, above and beyond the debates of each Member State. This is a space that we need to preserve and enlarge if we are to avoid the risk of fragmenting into separate national positions, thus making it much more difficult to perceive where the European common good lies. This is of course not a risk we run here. Here we are among friends, new and old ones.

I am glad that Professor Sylvester Eijffinger and Paul Welfens will be addressing us this afternoon on the EU and euro governance. They were already among the protagonists of the 1998 Jean Monnet conference on the European Union and the euro. I am also delighted that Professor Fritz Breuss could again be with us today. Professor Breuss' contribution at the conference 13 years ago showed

tremendous foresight. His treatment of fiscal federalism and his original proposal for the creation of a stabilisation fund read as if they had been written yesterday. The sharp pertinence of this analysis of 1998 underscores the importance of policymakers to listen carefully to the assessments made by the academic world, and that is precisely the function of these Jean Monnet conferences: to deepen the dialogue and mutual understanding between the policymakers and the flourishing community of expert academics.

When I say flourishing, I am notably referring to the application figures of this year. I am very glad that university demand for Jean Monnet support continues to be so high, with 617 Jean Monnet applications; a further 10 % increase compared to 2010. The Jean Monnet action is once again the most successful activity in the lifelong learning programme. With a 2011 selection, four new countries have been added to the Jean Monnet network, bringing the total number to 72 countries. And the quality of Jean Monnet projects is simply outstanding. This is not my assessment; it comes from the independent assessors of this action.

We can only be extremely pleased with such a healthy and dynamic state of play, and this comes in addition to the highly praised work at renowned institutions like the European University Institute and the College of Europe. I am proud to say that they have also found their rightful home in the Jean Monnet programme.

I am committed to ensuring that our Jean Monnet activities continue to prosper well into the future. I believe this is of vital importance. From the start, the basic idea underlining the Jean Monnet action was both functional and political. On the functional level, Europe needs lawyers, economists and other professionals who understand the *acquis communautaire* and are able to apply it. On the political level, the European Commission is convinced that knowledge and awareness of the workings of the EU are essential to promote a sense of involvement in Europe's development. Therefore, I am happy to take advantage of this occasion to confirm our support to your work. As President Barroso has already mentioned, the Commission yesterday has formally presented its future programme for education, training and youth for the period 2014–20, and the Jean Monnet activities are a key part of it.

Our proposal aims to take on the challenge of the Europe 2020 strategy, and to ensure its vision for the future: a future where Europe is back to the track of long-term growth and job creation. If we want our economy to prosper and grow, we need to ensure a steady supply of highly-skilled workers, and we need to mobilise the skills and competences of the unemployed. This is why we have proposed increasing the EU budget for education, training and youth for the multiannual financial period of 7 years. The new programme will be simplified and made stronger, and the Jean Monnet support will continue as a separate activity within the programme. Future Jean Monnet activities will focus on promoting teaching and research on European integration worldwide, notably through the continued expansion of Jean Monnet chairs and other academic activities. Whilst we will certainly not forget the need to continue our support for European integration studies in the Member States, we will give particular attention to specific geostrategic areas in line with the priorities of EU external action.

Let me briefly highlight four areas where I would like to focus our future work with you. First, I want to ensure the participation of a new generation of professors and researchers in Jean Monnet projects. We need your high-quality teaching and research on European Union topics to continue in the future. This is why I call on you to strongly encourage your younger colleagues to apply for Jean Monnet projects.

Second, European integration now touches all areas of society. This should be reflected in our educational curriculum. I therefore want Jean Monnet programmes to reinforce European integration studies in faculties not traditionally involved in the subject. Of course, such models would have to be targeted to meet the specific needs of the students in question.

Third, I believe that it could be beneficial to create a Jean Monnet label of excellence for those institutions interested in securing recognition of the quality of their European integration study programmes. Our new programme will provide us with a legal base to move in this direction.

Fourth, we are emphasising the think tank capacity of the Jean Monnet professors network. For the first time the proposed legal

basis makes an explicit reference to the Jean Monnet network's role in promoting policy debate and exchanges between the academic world and policymakers on EU policy priorities. I want to stimulate the openness of higher education to societal needs and the greater outreach of academics to civil society, for the mutual benefit of both.

Ladies and gentlemen, the European construction is facing momentous challenges, even beyond the economic and financial crisis: an ageing population; threats to the environment and to energy supplies; migration; internal and external security; the fight against terrorism; and the competitiveness of Europe in a globalised world. These challenges and the transformations they will trigger will have a fundamental impact on the lives of people both in and outside the European Union. The changes that the younger generations will see in their lifetimes are likely to surpass anything we have seen in our own. We need to solve the problems of the euro area effectively and swiftly because of the danger they pose to our Union, and because there are so many more fundamental problems that we also need to tackle. And we will only be able to tackle them if we will finally build a Europe that punches its full weight both economically and politically. In facing these challenges, I am convinced that the Jean Monnet network will continue to make a significant contribution.

Thank you once again for your presence, and for your commitment. I wish you a fruitful conference, and of course I look forward to the continuation of our cooperation.

Jan Truszczyński

We now move from the European Commission to the European Parliament. The European Parliament, as we all know, has been and remains a strong supporter of the Jean Monnet actions. The European Parliament, which is the lawmaker on all of the secondary legislation aimed at improving the performance of economic and monetary union, is a driving force in the entire debate on the future of European economic and monetary governance. For all of these reasons and more, it is a great privilege to welcome Anni Podimata, Vice-President of the European Parliament.

European economic **governance** in an international context



Anni Podimata

European Parliament

I would like to thank you for inviting me to participate, and to congratulate Commissioner Vassiliou for taking the initiative to organise this conference. Under the inspiration and guidance of the Jean Monnet programme and with the contribution of many distinguished speakers, some of whom are the most reputable Members of the EP and who helped draft and negotiate the six-pack regulation, this conference will enrich and open the debate for innovative ideas on economic governance and also on how we will deal with the current crisis.

As Mr Barroso pointed out, this has become a systemic crisis. Its systemic character is not only linked to the interconnected nature of the banking services, its systemic character also challenges our decision-making process at the national, EU and global level. It challenges the credibility of our political

systems and of our representative institutions.

Ladies and gentlemen, despite delays in the decision and implementation process, delays and deficiencies that have been early appointed by the EP, I believe that important steps have been taken to strengthen the provisions of the stability and growth pact, to further coordinate national budgetary policies and to enhance the cooperation of macroeconomic policies. Moreover, as you very well know, the EU Councils of July and October have reached significant decisions on strengthening the EFS mechanism and on dealing with the great crisis. But also, as you are fully aware, we need to do more, more quickly, in order to be able to reverse the

impression that we do too little too late. In other words in order to regain — this is something that we repeat very often now — market confidence.

I would like to point out though that equally important, if not more important, is the task of regaining European citizens' confidence. In order to do this I believe that we should make sure that we do not simply deal with the symptoms of the crisis but also address the underlying causes at the national, EU and global level. Undoubtedly, responsible fiscal policy and sustainable public finances are essential to stabilise and strengthen the common currency. I believe though that it is equally essential to deal with the inefficiencies of a largely unaccountable financial system that does not serve the real economy and increases inequalities. But I believe it is also true that our fiscal deficits have sometimes led to deeper democratic deficits: our citizens often feel more and more powerless, less and less represented by European institutions and political parties. They have lost faith in the EU because too many decisions are made behind closed doors by small groups of powerful leaders through processes that are not always transparent.

Let me make reference to the recent results of a Eurobarometer survey, according to which, throughout the recent crisis, EU citizens have developed a rather negative attitude to the EU's added value and have a clear and identifiable feeling that European leadership is missing while extremism and nationalism are present in almost all Member States with rising tendencies. But on the positive side, European respondents of the same survey say they are still expecting a strong European response to the crisis. So this is clearly what they are expecting from us; they want us to deliver. And the question is how? How to deliver? And I have a few answers to this question.

I believe that we can deliver by making a shift from the intergovernmental to the community method, because the community method combines efficiency, balance and democratic legitimacy. That implies full involvement of the European Commission and of the European Parliament during the whole decision-making process. By ensuring a balance between the necessary fiscal consolidation and growth enhancement, making stability in public finances not

the ultimate objective but a tool in the long-term objectives of job creation, growth and sustainable development, a tool in the achievement of EU 2020 goals. Ensuring strong taxation coordination across Europe is one of the basic pillars of stronger fiscal and economic coordination. By embracing ambitious policy instruments, such as the long-anticipated proposals on eurobonds, or the stability goals as the European Commission named them in yesterday's announcement and which were very much welcomed. As Mario Monti pointed out recently, it is clear that there is enormous work ahead of us and I firmly believe that if we manage to deal effectively and efficiently with all these priorities we do have a chance to successfully overcome this crisis, to restore calm and confidence to the markets and, again most importantly, to European citizens. And then, most probably, we will have the appropriate conditions in place in order to open a discussion on eventual treaty change. And this is, I believe, the right order to proceed. After all, as Monnet pointed out, I believe and agree that European integration will not happen with one big bang but in a step-by-step process.

Jan Truszczyński

I now have the great honour of introducing Professor Mundell and recalling the milestones of his academic career. Dr Mundell is University Professor of Economics at Columbia University in New York. Known as the father of the theory of optimum currency areas, he was actively involved in the European monetary unification from the early stages. In 1970, he acted as consultant to the European Monetary Committee and, in 1972–73, he was a member of the team who prepared one of the key reports on European monetary integration after the end of the Bretton Woods regime. In 1999, he received the Nobel Prize in Economic Sciences, and this is just the most well known of a series of prestigious awards. After receiving the Nobel Prize, Professor Mundell remained an engaged commentator of European monetary affairs and edited a book entitled *The euro as a stabilizer in the international monetary system*. I should add that it was published in 2000! Sir, it is a great honour to have you here with us today. May I kindly ask you to offer your keynote address.

II. Keynote speech

Robert Mundell

Keynote address



Robert Mundell

Winner of the Nobel Prize in Economic Sciences; University Professor of Economics at Columbia University; father of the theory of optimum currency areas

It is a great pleasure for me to speak at the Jean Monnet Centre and in the Charlemagne building, which has so much history attached to it. I have admired Jean Monnet as a great friend of the United States and one of the founding fathers of European unity. I mention the United States here because I have lived in that great country for much of my working life and will draw somewhat on its unique experiences when it was, like the EU today, a confederation groping with the need to press forward with deeper political integration.

In my remarks today I want to ramble over a number of issues all connected in some way with the current crisis of the eurozone and the direction political reform should take. At the outset I think I should emphasize that I do not share the widespread view that the crisis is a problem of the euro, but rather it is a crisis of fiscal solvency of some countries in the eurozone and the

challenge is to find a way of allocating fiscal responsibility and sovereignty between the eurozone leadership and its constituent nation state members.

Trichet's Aachen speech

In his Aachen speech on 2 June 2011, Jean-Claude Trichet of the ECB proposed central EU control of national budgets as the means of imposing discipline on countries that failed to keep their public finances in order. His question was this: in this Union of tomorrow, or of the day after tomorrow, would it be too bold, in the economic field, with a single market and a single central bank, to envisage a ministry of finance of the Union? He continued by saying that this could

possibly involve a transfer of power to the central authority in the field of taxation, although he was not completely committed on that.

Would a European minister of finance solve Europe's problem? The answer would depend on his powers. Suppose he had the same power as the Secretary of the Treasury of the US. He would have power over the federal budget, but none at all over the budgets of the individual states. This would be quite a lot of power in the US because the federal budget is more than 20 % of GDP. But in Europe the central budget is only 2 % of GDP and that would be hardly any help at all.

A minister of finance in Europe would contribute to a solution only if he had power to control the budgets of the sovereign nation states. As Trichet fully realises, this is a delicate political issue intimately connected with the issue of where sovereignty lies. The nation states could voluntarily cede that control over their budgets individually but could not be coerced without agreeing to a new treaty. Should the new treaty specify new powers of the central government that would shift functions now controlled by the nation states to a federal government or should it merely shift watchdog control or discipline over nation state spending and taxing to a federal authority? To make the point clear, should the functions of and revenues for big-budget items like social-support entitlements and defence be reallocated to the central state or should the central state merely have supervisory control or veto power over budgets, spending or taxation?

American experience

The formidable issue facing the constitutional convention in Philadelphia in 1787 was the issue of where sovereignty lies. The conventional wisdom then was that sovereignty had to reside in one place, such as a king. America had had enough of the king and wanted sovereignty to rest with the people. After the 1783 Treaty of Paris ending the Revolutionary War, the 13 states were formed into a confederation that was in some respects similar to the EU today. The 'Union' part in the name of the EU is a hope rather than a fact.

Confederations have a bad reputation. They move on to a federation or self-destruct. This was in the minds of the 13 states that

met in Philadelphia in 1787. Defence was an obvious pressure. The possibility that the 13 states might form three unions, not one with a north-eastern wing, a southern wing and a western wing, was an ever-present danger. The need for a common currency, perhaps a central bank like England and France and Holland, regulation of the free trade among the states and the potential for American expansion to the west were important issues. The support of Thomas Jefferson, the brilliant lobbying in the federalist papers authored (anonymously) by James Madison and Alexander Hamilton and above all the supportive father figure of General Washington, the hero of the revolution and 'first in the hearts of his countrymen' presiding over the Philadelphia Constitutional Convention, won the day, setting up the inaugural term of the United States to begin on schedule in March 1789.

Europe already has its euro currency, its monetary union (albeit with 10 members left out) and its central bank, so what interests us most here is the consolidation of state debts in a US public debt. One of the stumbling blocks in achieving that debt consolidation was the great disparity in debt ratios among the states, but Hamilton managed to finesse the issue with the argument (only partly correct) that the bulk of the disparities were produced in the interests of a common cause, the finance of the Revolutionary War.

After the consolidation in 1792, the states, which were sovereign over their own debts, could start with a clean slate of zero debt and were free to rebuild them. They did so but over a long period of time. About 50 years later, in the deflationary years of the late 1830s and early 1840s, several states defaulted on their debts. The largely British creditors asked their own government to assume responsibility for the debts but the latter pointed out that the states were sovereign entities with respect to their debts and left it up to the creditors to solve their own problems. The possibility of bailouts became a big issue in the United States but in the end the federal government left the problem up to the individual states to solve. Of the eight states involved (plus Florida which hadn't yet become a state), three states paid almost everything, other states shared the losses with their creditors and two states went to outright repudiation.

As it turned out, the states which were able to pay in full did so by tapping a new source of taxes — the property tax. Those states which defaulted in whole or in part already had property taxes, and thus could not access this feasible new source of revenue.

The defaults did not have any noticeable effect on the dollar (the US was theoretically on a bimetallic standard, but after the increase in the legal bimetallic ratio to 16:1 in 1834, overvaluing gold, it was on a de facto gold standard). The problem states were all able to come back into the bond market in a few years. There have not been any bailouts since. It remains to be seen, however, whether historical precedents would be enough to resist intervention in heavily indebted states like California and Illinois today.

The EU not initially a fiscal union

The Maastricht Treaty contained a no-bailout clause (clause 103) but it was overridden by another clause (clause 104) which condoned help to a state in trouble. Once the ice was broken, it became generalised. The problem was that many nation states, like especially Belgium, Italy and later Greece, were allowed in the Union with debt–GDP ratios far above the Maastricht levels. It was widely believed (and I believed it too) that a unique political moment in the integration of Europe had to be seized in 1999, and failing which the momentum of European integration would be lost and Europe's bicycle might come to a stop and fall over.

After Greece joined — a country with one third the GDP per capita of its northern partners — the issue of a potential default was widely discussed. Greece was not the only problem. Belgium, the very centre of the EU, had a debt–GDP ratio even higher than Greece and Italy. Belgium would have to be saved, but if Belgium, a rich country, why not Greece, a poor country?

The global boom of 2002–08 — arguably the greatest the world has ever experienced — put these problems on hold despite the fact that little progress was made to scale down the debts of the problem countries. But this optimism came to an end with the housing crash and the financial crisis that struck the United States in the summer and fall of 2008.

The soaring dollar against the euro in the summer and fall of 2008 aggravated the recession and brought on the insolvencies of several of the top financial institutions in the United States. The strong dollar delayed the spread of the recession to Europe but when it came the increased budget deficits put the high debt-ridden countries on the brink of insolvency. The first bailout, a EUR 110 billion loan from the eurozone countries and the IMF to Greece, was made in May 2010, followed up by the creation of the European Financial Stability Facility with a comprehensive rescue package of EUR 750 billion in the same month, with large amounts being dispensed to Ireland and Portugal. In the next year interest rates of large countries like Spain and Italy had raised the stakes and revolts against austerity had put the solidarity of the eurozone in doubt.

Whatever current measures are adopted to resolve the financial crisis in Europe, the eurozone must find a solution to the problem of achieving fiscal discipline in the individual states. There is no point to a grand strategy like debt consolidation or eurobonds if it does not fix the accountability and responsibility for deficits of the fiscally weak countries.

We know that there are two corner solutions. One is to restore the fiscal and debt independence of the nation states, playing hardball with respect to bailouts and taking away the immoral hazards of soft budget constraints. This was the direction the Americans took in the years between the creation of the United States and the Civil War (but we don't know if it will still work for the 21st century). The other corner is to move forward towards a strong central state with a ministry of finance that has control over national budgets as proposed by Trichet.

Ten years ago I would have been emphatically in favour of the first choice, on the principle of subsidiarity, decentralising decision-making and self-accountability. But I am not sure that today it is any longer possible. There is hysteresis. The steps taken during the current crisis have foreclosed on some options that might have been possible before the crisis. But it is also difficult to go forward toward increased centralisation because it requires a big shift of sovereignty to a central authority that does not yet exist. I wonder if there is any middle way.

Eurobonds, eurobills and the European Central Bank

An argument can be made today that an EMU (or EU, but let us sidestep that question for the time being) public debt would be beneficial. Despite the current crisis the euro is one of the two most important currencies in the world and an alternative to the dollar as a reserve currency and anchor. But the lack of EU treasury bills and bonds severely limits the power and usefulness of the euro as an international reserve currency. Buying individual national debts and bills of different degrees of solvency is a cumbersome alternative to the convenient and vast offerings on the US financial market.

This is not to say that becoming a reserve currency is an unmixed blessing. But the eurozone could take advantage of an opportunity for a source of funding of trillions of dollars that would be of tremendous use in buying time to resolve the current crisis. It will continue to be way behind the curve in the global competition for bills and bonds used to finance international trade and payments and for use in official reserves as long as its bonds and bills are splintered into 17 national offerings.

But there is another argument for eurobonds and bills that can be made. Quite apart from tapping new sources of funds internationally, the consolidation of national debts into eurozone debts would contribute to the eurozone's survival in its present constituency. There is now some risk that at least one country might decide to leave the eurozone. That would probably be a calamity for the country in question, but it would to some small extent tarnish the reputation of the euro. If the crisis spreads, the project of European unity could be back for a long time if not undermined forever.

We know of course from American experience that the creation of a US public debt in 1792 was not an unmixed blessing. Only a couple of decades later, it had become a vexing enough problem to produce a remark by Jefferson who said, in 1810, thinking of course of Hamilton back in 1792: 'And we were told that the public debt would be a blessing!'

Today these words might be echoed in nearly all of the democracies in the world. Ever since the breakdown of the international monetary system in 1971, fiscal discipline went out the window. Keynes was right when he referred to the convertibility mechanism as 'a means of strapping down ministers of finance'. Hamilton himself would be stunned today by the fiscal profligacy of democratic governments and onward march of fiscal deficits and debt ratios onward and upwards toward insolvency.

It must be acknowledged that there is some risk that debt consolidation could have a corrosive effect in increasing Europe's debt-GDP ratio; the same political pressures that have pushed the debts of the nation state to unsustainable levels could infect the central government. You can see this process operating in the United States where the federal deficits are close to record highs for a peacetime economy. To mitigate that, some restriction, perhaps even at the constitutional level, should be placed on deficits and debt levels. It would of course also be necessary to impose an outright prohibition on further national debt issues and something close to a balance-budget requirement for each participating nation state.

What would be the 'common cause' argument for the creation of a eurozone debt? A euro-debt level of about EUR 9 trillion would have a great international market if the risks of a eurozone breakup could be allayed. It would be a good rival to the US debt, which has over USD 5 trillion held abroad. The creation of a eurozone public debt would provide a strong incentive for non-members of the EU to join the eurozone and participate in the lower interest rates available to eurozone members.

The question is whether the creation of this debt would be at the expense of a surplus country like Germany. The equilibrium interest rate on eurobonds would probably be somewhat higher than that on Germany's debt, but not necessarily higher than it would be in the absence of debt consolidation and eurobonds in a situation where the eurozone crisis deepens. Taking into account the international market for eurobonds and eurobills the extra supply of international capital could keep interest rates on eurobonds at the international level.

Finessing the problem of sovereignty

Now we turn to the issue of sovereignty and again we take a look at the American solution. It was the ingenuity of the American founders at the Constitutional Convention (May to September 1787) that they were able to cut the Gordian knot on the question of sovereignty. The states wanted to be sovereign but federalists wanted sovereignty in the central state. The conventional wisdom of the late 18th century was that sovereignty could not be shared, and democracy was possible only in small republics; Rousseau had even said that the smaller the state the better. The Constitutional Convention provided for divided and overlapping sovereignties, in contrast to saying that sovereignty had to reside in one place.

The United States was the first country to create a nation-sized democracy dividing sovereignty between the states and the central government. The powers not allocated to the central government were reserved for the states.

At first it might seem that this division of sovereignty might solve the fiscal problems of Europe. But the division of powers was associated with the means of financing them. The central government had the responsibility for financing their mandates, and so did the states. But there was no arrangement for the central state to assume powers over state spending or deficits. What could be achieved either by constitutional amendment or else quasi-usurpation was that the central government could co-opt for itself new functions like social security, income redistribution and medical entitlements that never existed when the constitution was set up.

The European system is to organise the welfare state spending at the nation state level, whereas the American system achieves this at the federal level. General government expenditure in both the EU and EM was slightly over 50 % in 2010, of which social transfers accounted for 43 %, or 21 % of GDP. If social transfers in Europe were shifted from the nation state to the central state level, the weight of the central government in Europe's GDP would be at over 20 % close to its weight in the US. Of course appropriate taxes would also have to be shifted from the nation states to the central governments.

Under these conditions, Trichet's proposal of a European minister of finance would, if given the powers equivalent to that of the Secretary of the Treasury of the US, put European fiscal policy, from the standpoint of its control over spending, in the same position as US fiscal policy. In Europe total government spending would be about equally divided between federal and nation state level, whereas in the US state spending would be considerably smaller than federal spending.

I raise this issue now to propose this shift in spending at the present time, but to make clear that the share of sovereignty is pretty straightforward when it is accompanied by a shift in the share of spending mandates. But this is not the situation in Europe today. A shift of welfare state spending from the nation state to the federal level would involve a substantial redistribution of income from the richer to the poorer states. In the long run there may be much to be said for this redistribution on grounds of social solidarity but it was not part of the bargain made for entry into either the EU or EMU, and in any case it would be unfair to impose the burden of this redistribution all at once on one generation. If as I assume this shift of spending power to the central government is not politically feasible at the present time, we have to see what headway can be made with a shift of authority without the shift of spending mandates.

A natural model is the IMF, with its 187 members including the 17 EMU members. The IMF is an institution that imposes adjustment policies as a condition of its aid, and it has a multiplier effect because private-sector lenders (e.g. the Paris Club or London Club) often require compliance with IMF conditions as a prerequisite to lending or debt rescheduling or forgiveness.

Suppose that Trichet's eurozone minister of finance were suddenly interposed between EMU members and the IMF. To abstract from possible differences in expertise let us suppose that the relevant IMF staff is seconded to the euro minister of finance and that existing IMF policies are continued. This arrangement would give power to the EMoF without diminution of sovereignty from the nation states that has not already been given up to the IMF Board of Governors. But actually, the individual members of the eurozone affected would have reclaimed some sovereignty because they have a larger stake in EMoF decisions than they have in the IMF decisions. The

allocations of funds that would have been made by the IMF to their clients in the eurozone would now go through the EMoF.

Independent of an EMoF taking over some power from the IMF, there could be a ceding of sovereignty from the nation states to a central government in exchange for better benefit against insolvency.

European political reform

Actions taken today can promote or derail the cause of European political integration. It is important to look at the political institutions to see the desirable paths for them to evolve. The main institutions are:

- the Commission,
- the European Council,
- the European Parliament,
- the electorate.

What Europe needs is:

- an executive power,
- an upper chamber or senate that serves as the electoral college,
- a lower chamber or assembly,
- the electorate.

The Commission could be turned into the executive power with its cabinet/commissioners appointed by the president. The electoral college would appoint the president.

The European Council representing the governments could be turned into the upper chamber or senate and electoral college with the vice-president as its chairman.

The European Parliament could serve as the lower chamber.

The alternative to an electoral college would be the general election of the president. My own view is that in an area as diverse and

heterogeneous as Europe it would be better to elect the president and vice-president through an electoral college by majority vote. The extra attention given to the general electors of the electoral college would create a level of excitement and interest far above that of a Europe-wide majority vote.

The executive would nominate the judiciary with approval by the senate. The executive makes treaties subject to ratification by the upper chamber, and it proposes bills subject to ratification by both chambers.

The president is the commander-in-chief with a special protocol for British and French nuclear weapons. The lower house or assembly has around 500 deputies distributed among countries in proportion to population. Budget proposals initiated in the lower house must be accompanied by finance solutions. The Council of Ministers is expanded to the upper house and given certain special powers. In this model, with a total of 128 senators, countries with a population of over 80 million would have 12 senators; 65 to 80 million would have 10; 50 to 65 million would have nine; 35 to 50 million would have eight; and so on. You would then have a framework for division which isn't as rigid as that which determines the composition of the US senate and it would be a correction for disparities that exist in the senate, such as having two senators for Maryland, with a population of less than a million people, and an equal number for California with 40 million people.

In the electoral college, which votes for the president and the vice-president, each nation has electoral votes equal to the number of senators and representatives in congress. The presidential candidates with the majority of votes get the entire vote of the nation state.

The European Commission is a very successful institution. It is necessary to preserve some of its competence as a technical bureaucracy. Vice-ministers would be drawn from the civil service, but ministers would be members of the cabinet appointed by the president with the approval of the senate.

The international monetary structure

I would now like to make a few quick comments about the international monetary picture, which I believe has a great bearing on the future of Europe. In the world currency system, the biggest currency area is the dollar area, the second biggest is the euro area, the third biggest is the Chinese yuan area, the fourth is the Japanese yen area and the fifth is the pound sterling (or the rouble). A major problem in world finance since the early 1970s has been the huge swings in major exchange rates.

All the major systemic crises have been associated with large swings in the major exchange rates. Associated with these swings is a proliferation of crises including debt crises.

Over most of history since the invention of coinage, a kind of fixed exchange rate has characterised the monetary world because of the use of one or more of the precious metals as currency anchors. Currencies were names for different weights of the metals.

Whether the system was the gold standard or bimetallism or the Bretton Woods brand of fixed exchange rates based on the gold-convertible dollar, monetary and fiscal policies were constrained by a hard budget constraint — at least in the middle run. If during wars debt levels were run up, they were regularly brought back down after the war with surpluses invested into a sinking fund. If in the rare instance a country had a crisis or a large budget deficit there would be a run on its currency, and a currency crisis.

With the introduction of flexible rates, however, there came a very soft budget constraint. It was thought incorrectly that flexible exchange rates added another degree of freedom; this was true only if monetary stability were thrown to the winds. The only worry might be that you would end up creating inflation in the long run if you allowed too much money into the system, but you would not worry about the early warning system of a deteriorating currency. The Federal Reserve, for example, did not apparently worry about the depreciating dollar in the late 1970s and the two-digit inflation of the years 1979–81 came to it as a complete surprise.

You can see the analogy when a country like Greece gets into the euro with habits that it had formed in relation to what would happen to the drachma. When it got into the eurozone it could run deficits and pile up its debt level, polluting the debt pool of the whole euro area, without any constraint falling entirely upon itself.

Somehow, you need to keep discipline in the system. This has been a major problem for countries on flexible exchange rates leading up to all kinds of crises such as the sovereign debt crisis in 1982 starting with Mexico and Poland, the savings and loan crisis, the Asian crisis and finally the 2008 crisis.

I was debating whether I should spend my short remaining time here explaining my theory of the great crisis in 2008. It is that, in the third quarter of 2008, the Federal Reserve, in the middle of a recession, let the dollar soar by 30 %, knocking down all those banking institutions with real estate debt vulnerability and creating the unprecedented bankruptcies or insolvencies of premier institutions like General Motors, General Electric and others. Allowing a 30 % appreciation of the dollar against the euro in a space of 3 or 4 months was the major policy-caused problem that sent the financial system down.

Now we can see huge swings in the rate of the dollar to the euro. Under the Bretton Woods period, and even in the early 70s, the dollar represented the mainstream of the world economy. Now, with the rise of the EMS bloc and its culmination in the single euro currency, the mainstream has been split into two parts with violent swings between them.

A big problem now is the absence of a universal currency and a global unit of account. John Maynard Keynes, in his *A treatise on money*, wrote about the importance of the unit of account. The first line in his two-volume work reads: 'The unit of account is the most important function of money.' This is very important in today's world of international currencies. The euro is starting to become the currency for pricing certain things, such as airline fares, and you could argue that oil prices and the price of gold are more stable in euros than in dollars. It would be a shock to the system if oil prices began to be denominated in euros rather than dollars.

Stabilising the dollar–euro exchange rate to reform the system

The big swings in the dollar–euro exchange rate have not been to the advantage of either the United States or Europe. Both areas would be much better off with a stabilised rate and policy coordination that would keep the balance of payments in equilibrium. If you stabilised the dollar–euro rate you would have an anchor for the global economy. There is no possibility of a genuine international monetary system with big swings in the exchange rates between the two biggest currency areas. However, if the rate was fixed you would have a zone of stability that would represent over 40 % of the world economy. This could be the anchor for a global monetary system. You could build upon that with monetary coordination and stability of the common price level of the two areas.

In the long run, a fixed exchange rate requires compatible monetary policies. As the (moving) band between them narrowed, there would have to be increased coordination of interest rates and quantitative measures. You can't have any fixed exchange rate system in the long run without monetary coordination if there are two independent producers of money.

It is interesting to note that, for some time, the Chinese yuan has been tied to the dollar almost de facto, trending upward now and then. In 1997–2005 it's been fixed to the dollar and after that allowed to rise with a crawling peg until 2008. After that, with the dollar soaring the yuan was restabilised until the dollar returned to normal. My question is: could the yuan be part of the solution? It would be very easy to fix because China has found that a fixed rate with the dollar is the best way for a command economy to import the scarcity relationships of the rest of the world. The yuan would have to be made convertible and it would have to follow a monetary policy that brought about equilibrium in its balance of payments. The coordination of monetary policies in the dollar, euro and the yuan — what I call the DEY — would create a central core for the world economy, just by fixing two exchange rates and having policy coordination. You would then have 50 % of the world economy in that monetary reform, and other countries would have the benefit of a stable DEY bloc upon which they could fix their own currencies.

That is the way I think the world could go, looking outside the problems of just the euro area. It could move on from that to global monetary reform, creating a global currency and using the DEY currencies as the anchor for it. The euro-dollar could then become the central pivot for a restored international monetary system. A world currency, the INTOR, based on the euro-dollar as an anchor pivot, could be created for the IMF system as a whole in which every member of the Fund would share. It may be something which will materialise over the long term, but it is something that is necessary. It is not just ivory-tower academics that think so. Paul Volcker, the former chairman of the Federal Reserve and former advisor to Obama, has uttered what I call the Volcker imperative: the global economy needs a global currency.

Concluding remarks

I am now going to sum up what I have said. Great benefits could be achieved by the creation of a European ministry of finance, with some authority over the spending and deficits of the nation states. Great gains can be got for the euro area by the creation of eurobonds and eurobills, but it would be dangerous to create them without putting ceilings on government spending and deficits. Bringing the future to the present, the centralised fiscal authority should be put into place at an early date, eurobonds could follow, and in the interim, the ECB's firepower and tools for maintaining price stability could be built up.

It seems likely that the ECB will on occasion have to intervene in some markets to prevent insolvency when interest rates rise to dangerous levels over or at 7%. 'Discount freely in a crisis', Bagehot said. The choice might be that either the central bank intervenes, or the eurozone breaks up. The problem with intervention by the ECB to avert insolvency is that the amount of intervention might conflict with the ECB's mandate to give priority to macroeconomic stability and in particular inflation rate stability.

Some degree of expansionary monetary policy on the part of the European Central Bank is necessary for a solution to Europe. My own view is that the European Central Bank has been erring substantially on the side of being too tight in the context of the

deleveraging crisis Europe has been in. The Federal Reserve has gone far beyond what the ECB has done in satisfying the demand on the part of the banks for excess reserves. We are all aware of course of the ECB's mandate to avert inflation. But some risks have to be taken to avert insolvencies, which, theoretically, could result in higher inflation than otherwise. I'm suggesting here not a big step to inflation but a temporary movement up of inflation targets to say 3.5 %. That kind of shift could do much to relieve the situation and start a speedier recovery in the euro area.

I think that Europe should have a somewhat more expansionary monetary policy. But there is a possibility that the monetary expansion resulting from support for a particularly weak national bond market may exceed the rate needed for even a higher inflation rate. In this case, however, my suggestion is that the ECB can have recourse to a financial innovation that would let it support the bond market of a potentially insolvent country without causing excess inflation. The ECB could issue its own bonds to keep 'bailout policy' in line with monetary stability, in effect to sterilise the some of the monetary effects of bailout policy.

Other central banks have done the same but in a different context. Which banks? The answer is China. The PBC issues its own bonds to mop up any excess reserves created by the purchase of dollars in the foreign exchange market to keep the yuan from appreciating (or from appreciating at too fast a rate).

ECB bonds would add a new instrument for preventing inflation. Suppose for example, EUR 400 billion is needed to avert a solvency crisis. But only EUR 200 is needed for monetary policy objectives. If the ECB had no other tools of stabilisation, it would have to restrict its intervention to what was needed for monetary policy alone. But with ECB bonds available, the ECB can go ahead with its EUR 400 billion anti-insolvency intervention, and then sell EUR 200 billion of ECB bonds to sterilise the excess inflationary component of the intervention.

Ultimately, ECB bonds are debts of the European Union. Eventually, when Europe creates its own Eurobonds, these ECB bonds could be absorbed into the debt of the EU. But the ECB bonds could be

useful instruments during the transition period before eurobonds and eurobills are established. There is an urgency for fiscal reform, but it seems hard to make such weighty changes quickly. But when we look back at what those Americans accomplished, back in 1787, it is astonishing to see how quickly they were able to act. Within a year or two of the Constitutional Convention, they had a first-rate government in place and in the last year of Washington's first term as president, they had created a national money, a monetary union for 13 states, a central bank and a consolidated public debt. When the chips are down, there is much that Europe can do too.

Jan Truszczyński

Professor Mundell, on behalf of all those here today, allow me to thank you most warmly for this address. It was an excellent scene setter and I am sure that many people here will want to refer back to elements of the design proposals, or even to the entirety of the design which you formulated here today. Thank you very much.

III.

Safeguarding the stability of the euro area and the enhanced instruments for crisis intervention

Roberto Gualteri

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Safeguarding the stability of the euro area and the **enhanced** instruments for crisis intervention: political and institutional dilemmas



Roberto Gualtieri

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This conference is taking place at a particularly appropriate moment for us to discuss the stability of the euro area. On the one hand, the sovereign debt crisis is getting worse each day; on the other hand, the debate on enhanced instruments for crisis intervention has gained momentum, not only with the Commission Green Paper on stability bonds and the two new draft regulations on strengthened budgetary surveillance in the euro area, but also with the German request for a limited treaty change. As a member of the Constitutional Affairs Committee, I focus my intervention on what in this debate appears to be one of the main obstacles to an adequate reaction to the crisis: the limits imposed by the treaties on eurozone policies. In a few words, I will try to answer the following question: is the Lisbon Treaty the main obstacle to us reacting effectively to the crisis? Does the EU have an institutional problem, or a political problem? Both the Commission Green Paper and proposals, and Merkel's request for a treaty

change deal with this question, with different answers, but also with some common elements.

Before examining those answers, I wish to recall a recent example of how conflating a political difficulty with an institutional

obstacle may cause unnecessary problems, and waste time. One year ago, Germany said that the legal basis for the current EU stability mechanisms (EFSF and EFSM), that is Article 122(2) TFEU, was inadequate and that we needed a treaty change. With the new simplified revision procedure, a new paragraph was introduced to Article 136, empowering the Member States (and not the Union) to establish the ESM. After 1 year, the treaty change is far from being ratified, the German Constitutional Court (BVG) has said that both the EFSF and the EFSM are completely legal, that is that Article 122(2) provides an adequate legal basis, and after the 21 July decisions the tasks of the EFSF have been stretched far beyond the limits imposed on the new ESM. The reasons why this treaty change was unnecessary have been clearly expressed in the European Parliament's opinion, so I will not reiterate them here, but this story is a very clear example of what I will try to say.

The German request for a treaty change identifies the main limits imposed by the treaties as the insufficiently binding character of the provisions concerning the Stability and Growth Pact and the excessive deficit procedure. As far as we are aware, the German government is asking the EU to introduce simple majority voting in multilateral surveillance, to allow the intervention of the CJEU in the excessive deficit procedure and to try to give the Commission the powers to interfere in the national budget procedure in order to enforce EU decisions.

I will not discuss whether those changes would have any positive impact on the crisis. Personally I consider the austerity therapy wrong and counterproductive, even if the EU needs stronger control of national fiscal policies and a drastic but sustainable reduction of its public debt, combined with a correction of its macroeconomic imbalances. Furthermore, the recently approved 'six-pack' has significantly strengthened the SGP and made it more binding, and its impact in enhancing fiscal discipline appears to be widely underestimated, even by national governments and policymakers. However, here I concentrate only on the institutional dimension. Do the goals which are at the basis of the German request really require a treaty change? My answer is no. As the new draft regulations presented by the Commission show, and as the Parliament has been saying for a long time, the treaty offers many instruments for a stronger convergence of eurozone fiscal policies.

One is the result of Articles 5 and 136 TFEU, which allow specific measures to strengthen the coordination and surveillance of the budgetary discipline of eurozone countries. The two draft regulations are a clear example of what I am saying, but the same procedure might be applied for introducing stricter rules and also for bypassing the limits imposed by Articles 121 and 126 TFEU on voting procedures and role of the CJEU, as those limits refer to the provisions of those articles and not to possible new provisions introduced under Article 136.

The second instrument offered by the treaties is the so-called flexibility clause under Article 352 TFEU, which allows the Union to give the EU institutions new powers which may prove to be necessary to attain objectives set out in the treaties. Among those powers there could also be those of a new EU finance minister for the eurozone, or of a new debt agency. The limits to the interference of this minister in the national budgetary procedure would depend more on the national constitutions than on the European treaties, and would not be overcome by a treaty change. The BvG has granted the flexibility clause the same value as a treaty change. That means not only that it requires the same kind of vote by the Bundestag (but before and not after its activation), but also that it has no problems of constitutional legitimacy, and is in any case far more rapid than a treaty change. The main difference with a treaty change is that the flexibility clause requires the consent of the European Parliament, which is probably the reason why the Member States do not want to use it. The flexibility clause might also be associated with Article 136, activating it with the vote of the eurozone countries only, which would make its use even simpler.

The conclusion is that the treaty change proposed by Germany is legally unnecessary, economically insignificant and politically dangerous. Of course a fully fledged fiscal union would require a more ambitious treaty change, but the best way to prepare it and to make it more realistic is to start immediately to build up an effective fiscal union with the institutional instruments we already have. Among those instruments I do not include an intergovernmental treaty, which risks being the consequence of the difficulties to get unanimity on a treaty change, but which would have no

practical effectiveness on economic governance, and would hardly go beyond what we already have with the 'six-pack'.

This need for speed and effectiveness is even greater for the stability instruments. In this respect the Commission Green Paper has the great merit of opening a true institutional debate on stability bonds, and to show clearly how much they would be useful and necessary. The Green Paper is very rich in detail, and I will not analyse the different options. I am not entering into the debate as to whether the full or the partial substitution system would be better. From the institutional point of view, the true difference is between a system based on joint guarantees and another based on guarantees which are not joint. It is clear that to implement the first option (joint guarantees) Article 125 TFEU is an obstacle, even if its second clause, which leaves open the possibility to specify the definitions in Article 125 (and those in Articles 123 and 124), may open the same legal options, especially for the issuance of new bonds guaranteed by the Union budget.

But the Green Paper cleverly suggests a combined approach based on sequential steps, which may start with the immediate issuance of stability bonds, with several but not joint guarantees, and the partial substitution of national issuance. In the logic of the Green Paper, this first step, which does not require any treaty change, might prepare the most ambitious step of a joint guaranteed bond, given the time needed for a treaty change. The disadvantage of this option, apart from the political opposition of Germany, is that, especially if the tensions in the markets increase, it might not be sufficient, both in terms of credit quality and in terms of resources gained. What I would argue here is that the institutional issue could also be seen from a different perspective, not focusing only on Article 125, and that this different perspective may suggest some further options that are both quick to implement and economically effective.

Again, one should start to look at what we already have. We have Article 122(2), which is the legal basis of the current EFSF and EFSM, and which allows the Union to grant financial assistance to Member States seriously threatened by exceptional occurrences beyond their control. This legal basis, which perfectly reflects

the current situation, might be used to implement two different solutions.

The first is the solution envisaged by the German Council of Economic Experts, which is briefly examined also in the Green Paper, even if it is not listed among the main options. The German Council of Economic Experts proposes a temporary financing tool, a so-called 'debt redemption fund', which would pool government debt exceeding 60 % and be liquidated once that goal is reached, but would be based on joint liability. This idea of eurobonds as a crisis tool rather than a permanent instrument would not only bypass the limits set by the recent ruling of the BVerfG and by the German constitution, but would also fit perfectly with the particular legal basis of Article 122(2), perhaps requiring only the activation of the flexibility clause or even just a decision and a regulation under Article 122(2). The debt redemption fund would provide sufficient firepower to address a deterioration of the sovereign bond market immediately, and at the same time allow the time for more wide-ranging reform of the treaties in order to establish a permanent stability bonds system in the context of a fully fledged fiscal and democratic union.

A second option based on the same legal basis would be the enhancement of the current EFSM, which as a Community instrument is not guaranteed by individual quotas of the eurozone Member States, but by the Union's budget, more precisely by the (virtual) resources between the MFF and the limit of the own resources. Notwithstanding the fact that everybody seems to have forgotten it, the EFSM exists; it has not been put into question by the German Constitutional Court. Its only limit is political, as it involves also the UK and the other non-euro countries, which guarantee with their share of the Union's budget the issuing of bonds for the euro countries in difficulty. This problem might be overcome by a rebate system, while the problem of the quantity of resources could be solved either by increasing the limit of their own resources or by contributions of eurozone countries.

We have also a third option, less ambitious because based on leveraging, but which could be also very effective: the transformation of the EFSF into a bank (as suggested amongst others by Daniel Gros and Stefano Micossi), which would bypass the prohibition

of credit facilities with the ECB set out by Article 123(1) TFEU, as Article 123(2) says that the prohibition shall not apply to publicly owned credit institutions.

Of course, these considerations are only a first reaction to the new documents and proposals of the Commission, as well as to the leaks about the German plans for treaty change. But, coming back to the question I asked at the beginning of my intervention, the conclusion I would like to draw is clear. We don't have institutional but political problems, and they will not be solved by a treaty change, but by the political determination to take action now, using in an intelligent way all the institutional tools we have, without losing more time. At the end of this process, the EU will need a comprehensive treaty change, but it will succeed and will be supported by the European people only if the political leadership demonstrates that it is able to save Europe from the worst crisis since the Great Depression by taking the necessary decisions now.

Safeguarding the stability of the euro area and the enhanced instruments for **crisis** intervention



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Introduction

The sovereign debt crisis in the euro area during the spring of 2010 has revealed that the monetary and fiscal policy framework of the European monetary union (EMU) is still incomplete. Obviously, the rules-based framework for fiscal policy created by the excessive deficit procedure (EDP) and the Stability and Growth Pact (SGP) was insufficient to prevent a debt crisis despite its emphasis on keeping public sector deficits low and strengthening forward-looking budgetary planning. Moreover, once the crisis occurred and financial markets were agitated by it, it became obvious that EMU did not have the policy tools to manage and resolve the crisis. In the end, the European Union responded to the crisis first by agreeing on stabilisation for Greece and then by creating the European Financial Stability

Facility (EFSF) that relatively succeeded in calming the markets. However, these responses were developed in an ad hoc manner and on a temporary basis only and do not provide a sufficient basis for dealing with any possible future debt crises in the euro area.

Several proposals have been put forward for how to improve the euro area's capacity to deal with problems of excessive public debts. In order to prevent sovereign crises, the European Commission (2010) has proposed a number of measures to strengthen the EDP and the SGP. These proposals focus mainly on making the rules of the current framework more effective and on strengthening

their enforcement by introducing stiffer and more automatic penalties for violating these rules. The European Central Bank (ECB) has made proposals (2010) going in the same direction and, at the same time, has called for the creation of a crisis management fund for the euro area, which might encompass some lender-of-last-resort characteristics (Gianviti et al., 2010).

The European Council of 28 to 29 October 2010 stated that 'Heads of State or Government agree on the need for Member States to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole and invite the President of the European Council to undertake consultations with the members of the European Council on a limited treaty change required to that effect' (European Council, 2010). There are also reports that the German finance ministry has been preparing a proposal for coordinating the demands of bondholders in a sovereign debt crisis and imposing 'haircuts' on the face value of the debt of a government in financial distress. There have been several plans along similar lines, most notably by Gros and Mayer (2010) who proposed the creation of a European Monetary Fund (EMF) aimed at both improving crisis prevention and financing a mechanism for sovereign debt resolution.

The euro area needs a mechanism for dealing with sovereign debt crises in an effective and predictable way. Even the most sophisticated and most effectively enforced set of fiscal rules will not eliminate the possibility of future debt crises in the euro area.

A new European economic convergence

Policymakers in Europe must now concentrate their action on at least three areas (Draghi, 2011).

First, they need to deliver the growth-friendly fiscal adjustments they have committed to implement.

Second, they need to focus on the structural reforms that Europe needs in order to boost potential growth; current problems in many countries stem as much from excessive debt as from the weak economic growth expected in the years ahead.

Third, they need to agree on a thorough reform of European economic governance. The crisis highlighted some major shortcomings. Fiscal rules and procedures have proved unable to deliver prudent policies: many Member States entered the crisis with an already high public debt and insufficient margins of manoeuvre. Moreover, macroeconomic imbalances were not given an adequate role in the design of EMU governance: tensions hit not only countries with problems of public finances, but also those with a high external deficit, unbalanced growth and/or a highly indebted private sector. Finally, an appropriate framework to safeguard the financial stability of the euro area in crisis situations was missing altogether.

Reform proposals have been set out in all the three areas, by the European Commission and the task force, chaired by President Van Rompuy.

Concerning fiscal surveillance, the report of the task force states that ‘the debt criterion should be made operational to be effectively applied’. It is well known that, while the Maastricht Treaty requires countries with high public debt to reduce it ‘at a satisfactory pace’, this provision has never been effectively implemented. The report also envisages a wider range of sanctions, both financial and political, to be applied progressively, starting at an early stage in the budgetary surveillance process, in order to strengthen the incentives to comply with the rules in good times to avoid procyclicality effects. However, the procedures remain too lengthy.

With regard to the surveillance of macroeconomic imbalances, the task force proposes an alert mechanism, based on the analysis of macroeconomic and competitiveness developments, and an enforcement mechanism that includes sanctions if a country in ‘excessive imbalance position’ does not comply with the Council’s recommendations. As the crisis showed, macroeconomic imbalances may lead to unsustainable development and dangerous spillovers to other countries ⁽¹⁾.

⁽¹⁾ See, for example, Giavazzi and Spaventa (2010).

A crisis management framework has to be designed so as to ensure appropriate incentives for countries applying for financial support and for private credit markets, in order to limit moral hazard. At the end of November 2010, the Eurogroup agreed on the main features of a crisis management framework aimed at safeguarding the financial stability of the euro area as a whole. In particular, it has: (i) stressed that assistance will be based on a stringent programme of economic and fiscal adjustment and on a rigorous debt sustainability analysis; (ii) clarified that the mechanism does not represent an unconditional bailing out and that there is always a possibility that private creditors may incur losses if the country concerned does not succeed in implementing the necessary adjustment.

The reformed stability and growth pact, the new excessive imbalances procedure and the Euro Plus Pact will reinforce the economic and fiscal coordination and surveillance in the euro area and ensure that any deviation from the objectives set by these instruments are recognised and addressed at an early stage. This policy of prevention will be crucial to the medium- and long-term stability of the euro area.

At the same time, establishing the EFSF and, from mid 2013, the European Stability Mechanism (ESM) will enable targeted intervention if indispensable to safeguard the stability of the euro area as a whole — always subject to adequate conditionality. Member States which benefit from the EFSF undertake considerable efforts to tackle the causes of the crisis — principally excessive public debt and a lack of competitiveness — effectively.

All the Member States of the euro area have committed themselves to swiftly reducing their deficits, achieving balanced budgets in the medium term and implementing the structural reforms required to enhance the competitiveness of their economies on a sustainable basis, namely:

1. Strengthening the governance of the euro area

All the decisions taken in the last year are aimed at enhancing stability and fostering growth in all Member States. In order to support

this process, the euro area needs to strengthen and streamline its institutional framework to reinforce the efficiency of its decision-making process and to promote the coherence of its institutions and procedures.

2. Enhanced surveillance and integration of budgetary and economic policy

Economic and monetary union needs to be based on an even closer coordination of national budgetary and economic policies.

It should be further enhanced through the following proposals.

- All Member States of the euro area will incorporate a balanced-budget fiscal rule into their national or constitutional legislation. The fiscal rule should implement the objectives of the SGP and ensure that every Member State of the euro area achieves a balanced budget as soon as possible. Therefore, it would ensure a sustained reduction of the debt ratios in the case they exceed the reference value (60 % of GDP). In line with the revised SGP, all Member States of the euro area whose debt level exceeds the reference value must present an adjustment path for reducing their debt below the reference value.
- All Member States of the euro area should confirm without delay their resolve to swiftly implement the European recommendations for fiscal consolidation and structural reforms, especially as regards the labour market, competition in services and pensions policy, and adapt their draft budget appropriately.
- In line with the Euro Plus Pact, euro area Member States should take all the necessary measures to improve competitiveness, foster employment, ensure the stability of the euro area as a whole and deepen economic integration. In particular, further progress should be made on tax policy coordination to support fiscal consolidation and economic growth.
- Structural and cohesion funds should be used to support essential reforms to enhance economic growth and competitiveness in the euro area. The European Commission should automatically check to ensure that structural and cohesion funds provide the optimum support for the macroeconomic adjustment programme, and they should be involved in the selection and

implementation of projects. In the future, payments from structural and cohesion funds should be suspended in euro area countries not complying with recommendations under the excessive deficit procedure.

Concluding remarks (2)

In summary, it has been shown that the euro area requires:

First, a stronger commitment on the part of countries to effectively prevent the pursuit of unsustainable fiscal policies and the emergence of other harmful macroeconomic developments.

Second, if imbalances in public finances, significant losses in competitiveness or excessive macroeconomic imbalances nonetheless emerge, robust corrective mechanisms must come into force. There must be an appropriate degree of automaticity to ensure that these mechanisms are not open to wide interpretation or to undue political discretion.

Third, in the unlikely event that the reinforced preventive and corrective arms of the proposed enhanced framework are unable to prevent a crisis in the future, the euro area would benefit from a well-designed permanent crisis management framework.

Fourth, with regard to the debt reduction, the Commission proposal must be seen as the absolute minimum, as it may not constitute a sufficient incentive for fast debt reduction for countries with high debt and relatively robust nominal GDP growth. With regard to the assessment of compliance with the debt criterion, relevant factors should only be considered when the government debt ratio will decline over a 3-year horizon according to the Commission's forecasts. Irrespective of whether the debt ratio is above or below the 60 % of GDP reference value, when assessing whether the deficit is excessive, the relevant factors should only be taken into consideration if the deficit ratio, before taking into account such factors, is

(2) See European Central Bank (2011).

close to the 3 % of GDP reference value and the excess over the reference value is temporary, in line with the current rules.

Fifth, general exemption clauses, which are proposed under the preventive and corrective arms of the SGP, should not be implemented. The application of the SGP in past years lacked the discipline needed to achieve sustainable fiscal positions before the crisis.

Sixth, greater automaticity is required in all surveillance procedures, including the new macroeconomic surveillance framework. When Member States fail to comply with recommendations to adjust their policies, this should lead to the consequences provided for in the preventive and corrective procedures, and the Council should have less room for halting or suspending procedures against the Member States.

Seventh, the macroeconomic surveillance framework should have a clear focus. In particular, it should focus on euro area countries with large current account deficits, significant competitiveness losses or high levels of public and private debt, as well as any other vulnerability threatening EMU.

Eighth, financial sanctions should be applied at an early stage and gradually within the macroeconomic surveillance framework to provide clear and credible incentives for countries to adopt appropriate macroeconomic policies.

Ninth, a new economic governance framework should include a crisis management framework that safeguards the financial stability of the euro area as a whole if one or more countries experience a sovereign debt crisis.

In creating a crisis resolution mechanism, Europe is taking the lead where the international community failed to find agreement a decade ago. There are good reasons to think it has a fair chance to succeed, and we do not share the view of those who claim that no European solution can be found in the absence of a global solution. By the same token, however, we certainly consider that there would be significant benefits in the definition of a global response to the sovereign crisis-resolution issue, and we hope that Europe's

decision to create a regional mechanism will help advance the global discussion.

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Liquidity in times of crisis: even the ESM needs it



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Abstract

This contribution argues that the permanent European rescue fund, the ESM, should be provided with a liquidity backstop by having it registered as a bank — and treated as such by the ECB. Should the crisis become again more acute, a renewed generalised breakdown of confidence could then be stopped because the ESM would stand ready to intervene in secondary markets or recapitalise banks, potentially with almost unlimited amounts. Access to central bank financing becomes crucial in a crisis because when risk aversion increases not even the ESM might be able to raise quickly the hundreds of billions of euros that might be required at very short notice to prevent a breakdown of the financial system.

Once the ESM can refinance itself at the ECB the central bank could be restricted to the classic function of a lender of last resort, leaving the management of public debt under the supervision of the finance ministers which run the ESM. The ECB could still manage area-wide liquidity as the 'ESM bank' (effectively a European Monetary Fund) would be subject to the same rules as all other banks and as the ECB would accept only good quality collateral from it. Moreover, the ECB could abandon definitely its purchases programme of peripheral government bonds.

NB: This contribution is based partially on Gros and Mayer (2012).

Introduction: sovereigns like banks

Canaries were kept in coal mines because they die faster than humans when exposed to dangerous gases. When the birds stopped singing, wise miners knew that it was time to gear up the emergency procedures. Greece, as it turns out, was the eurozone's canary. In 2010 the canary was resuscitated, and a small rescue mechanism was set up to revive a further canary or two — but beyond this the warning was ignored. The miners kept on working. They were convinced that the canaries had overeaten and just needed a diet to get well again.

But the problems of Greece should have been seen also as the first manifestation of a general problem, namely that the global crisis was spreading to public debt as capital markets refuse to refinance excessive levels of public debt, especially in the eurozone, whose members can no longer rely on central bank support.

The Maastricht Treaty explicitly ruled out any form of 'monetary financing' for governments. This was done to safeguard the independence of the ECB and thus ensure that governments would be forced to follow sound fiscal policies. However, while this prohibition of financing deficits via the printing press was needed to safeguard price stability, it can create a problem when risk aversion increases so much that even solvent borrowers can no longer roll over their debt. In such a situation liquidity becomes key, both for the sovereign and the banking system.

For the sovereign the problem can be summarised as a maturity mismatch issue: a government has long-term assets (flow of tax revenues) and liabilities of a much shorter duration. A country with a balanced budget would normally be considered solvent even if the debt to GDP ratio is 100 % because with a balanced budget the debt to GDP ratio will decline towards zero as long as GDP grows in nominal terms. However, even if the average maturity of government debt is 8 years (rather conservative and almost the case for Italy) the same country has to refinance every year 12.5 % of GDP: much above what even the strongest government could hope to finance out of a surplus. This implies that any government could become immediately insolvent if investors refuse to roll over the

debt coming due. This is exactly the same mechanism as in a bank run. A bank has typically long-term assets (loans) but short-term liabilities (deposits). If all depositors want their money back at the same time the bank will not be able to liquidate immediately its loan portfolio (Diamond and Dybwig, 1983).

The danger of a run on government debt does not exist for a country with its own national currency (as long as government debt is in local currency) because then the national central bank can provide the liquidity needed to keep the sovereign solvent in the short run, even in case of a total investor's strike. The potential for bank runs and their widespread occurrence during the 1930s was the main reason why central banks became the lender of last resort for banks. Within the euro area, national governments, similarly to banks, need a liquidity backstop (see also de Grauwe (2011) and Kopf (2011)).

The key problem is of course that any liquidity backstop mechanism — whether for banks or for sovereigns — requires by definition a distinction between insolvency and illiquidity.

For banks the final decision is usually taken by the fiscal authorities. We argue (see already Gros and Mayer (2011)) that one should follow the same approach also for euro area sovereigns.

Moreover, even a 'suprasovereign' institution like the ESM could be subject to the same problem. After all the ESM has only rather long-term assets, namely the taxing power of the Member States which have subscribed to its capital (and given the promise to pay a certain share of the liabilities of the ESM).

It is entirely possible that one day even the ESM will not be able to place all the bonds it would like to issue. The ESM is likely to need to go to financial markets when risk aversion is high because that is when peripheral euro area countries are likely to experience difficulties themselves. During these times the market might also become more wary of the political commitment of the remaining core countries to support and might not absorb the hundreds of billions which might be needed quickly. This is the fundamental problem which remains unresolved so far.

The summer of 2011: the anatomy of a crisis

The problem created by the absence of a lender of last resort for the sovereign became particularly acute after the July 2011 European Council, which was supposed to end the crisis by settling the Greek case with a mixture of generous long-term financing at low interest rates and some private sector rescheduling and restructuring. The result of this summit was the opposite of what it set out to achieve as the crisis entered an even more acute phase with investors anticipating the quick nature of the 21 July 2011 'solution' (an anticipation which proved to be correct).

The markets noticed the first ever official announcement of a 'voluntary' haircut on private investors in government bonds of an EU member country and re-evaluated all their holdings of all peripheral government debt. The European Council officially assured investors in July 2011 that Greece was an 'exceptional and unique case'; and this assurance has been repeated ever since. However, investors were not fully convinced then (and still are not today) because at least one other country (Portugal) is facing a fundamentally similar problem to that of Greece, at least in terms of overconsumption and foreign debt ⁽¹⁾. Moreover, the size of the haircut initially proposed (21 %) was clearly unrealistic from the outset and indeed increased to approximately 80 % when Greece effectively defaulted in March 2012.

Whatever the official promises, with the official announcement that private investors would be required to make losses on their holdings of Greek government bonds, a sort of Pandora's box was opened because this meant that, potentially at least, other countries with high debt levels might end up in a similar situation. This opened the potential for vicious feedback loops. The argument is quite simple: even a rather high level of public debt would be sustainable if the government had to pay only a low interest rate, say, close to the compensation required on a riskless investment. However, the same level of debt might become unsustainable, forcing

(1) See Gros (2010).

a country into default, if the borrowing cost is much higher. Hence many authors (most persuasively de Grauwe (2011)) have argued that there might be multiple equilibria: if the market thinks the government can pay it will be able to pay because its borrowing cost will be low. However, if the market thinks the government cannot pay, in practice it will not be able to pay because the high-risk premium requested will make the debt service so expensive that it will not be able to find the necessary resources. Doubts about the ability of a government to service its debt could thus become self-fulfilling.

This mechanism is similar to the maturity mismatch described earlier. However, it works more slowly and becomes less likely the longer the maturity of government debt. But the fact that high interest rates can become self-fulfilling prophecies about the ability of a country to service its debt provides a justification to provide, under exceptional circumstances, fundamentally sound countries (those countries which are solvent at a reasonable risk premium) with financing at lower-than-market rates. But the question that then arose in 2011 was simply whether there was enough money for everybody.

The Greek public might not appreciate it, but it has received preferential treatment from the EU. The offer to Greece was to have essentially all its financing needs arranged for a decade whilst paying less than 4% on the new debt. Moreover, given that the country has little private debt left after the PSI it is clear that even the public creditors will in all likelihood have to agree to a de facto haircut as well once the new programme goes off track.

In 2011 the two other countries with a programme, Ireland and Portugal, had to be treated 'equitably'. So they were also given more lenient terms (low interest rates and longer maturity) and the implicit assurance of further financing should they not be able to face the test of the markets in a few years.

But while Greece, Ireland and Portugal obtained more generous official long-term financing, Spain and Italy experienced a surge in their borrowing costs in the summer of 2011. At that point the debt fears started to affect even the core, with peaks in the spreads for France

and even the Netherlands. The reason for this contagion is quite simple: there is not enough highly rated fiscal power in the eurozone. Germany cannot pay for everybody and countries like Italy and Spain cannot be expected to provide billions of euros in credits to Greece (and Portugal and Ireland) at low rates (approximately 3.5 %) when they are themselves paying much more. Europe's leaders wanted to be generous to Greece, Ireland and Portugal. But the supply of cheap funds is limited. Not everybody can be served this way.

The EFSF and the ESM can only deal with a peripheral crisis

The eurozone's permanent rescue fund, the ESM (which will supersede the European Financial Stability Fund (EFSF) in the course of 2012), cannot provide everybody with financing on the scale required so far by the GIP. It simply does not, and will not, have enough funds to stabilise Spain and Italy as well. Although the EFSF and the ESM might run in parallel the overall financing volume of about EUR 500 billion which will be available in the long run is just sufficient to take care of the small peripheral countries like Greece, Ireland, and Portugal. But would clearly be too little to face the massive contagion which might result from a Greek exit.

Moreover, any financing that relies on guarantees and other contributions from Member States separately is vulnerable to a domino effect. Countries facing high borrowing costs cannot effectively be relied upon to provide contributions to the rescue fund (whether the EFSF or the ESM). This does not matter that much as long as only small countries are in trouble. But if (when) the borrowing costs of large countries like Italy and Spain (which account together for about one third of the eurozone GDP) increase further and pass the widely accepted threshold of 6-7 %, only the core eurozone members would remain to back the EFSF. At this point, the debt burden on the core countries would become unbearable and its own borrowing costs might even increase. Events in 2011 showed this clearly. Even France experienced market pressure as doubts arose over its ability to deal with the contingent liabilities from the rescue of others on top of its already large existing stock of debt.

This implies that a larger rescue fund is not the solution, if anything it can accelerate the domino's fall ⁽²⁾. The widely held view— that the fire-power of the EFSF/ESM should be increased — does not make sense ⁽³⁾.

In the summer of 2011, the domino effect started to operate because financial markets do not wait for country after country to be downgraded; they tend to anticipate the endgame, or at least one potential scenario, namely the collapse of the entire EFSF/ESM structure. Markets were caught between three seemingly inconsistent constraints: (1) Little chance for a sizeable increase of the borrowing capacity of the EFSF; (2) little chance for the introduction of eurobonds; and (3) great reluctance of the ECB to engage in large-scale purchases of bonds of financially troubled governments.

In the end the ECB ended up buying large amounts of Spanish and Italian debt, but it was clear from the outset that it would never do so on the scale required to permit all investors to exit. The ECB has since stopped its bond buying programme since it has become clear that its task cannot be to prop up sovereign debt markets indefinitely.

The bank–government–debt snare

As usual, banks are the weakest link. They create negative feedback loops and accelerate the transmission of the domino effect. There are two reasons for this:

- many banks hold large amounts of government debt;
- their credit rating usually falls along with that of their own sovereign.

⁽²⁾ See Giovannini and Gros (2012) for a calculation of the size of the EFSF/ESM needed to deal with Spain and Italy.

⁽³⁾ This should be the case in particular for the country whose government has been most active in pushing for an increase in the funding for the ESM because financial markets have understood this risk and are driving up borrowing costs for France — the core country most in danger of losing its AAA rating. But if France definitely loses its AAA status only Germany (and some of its smaller neighbours) would be left and have to carry the whole burden. This would be not only politically unacceptable but also economically impossible — the Italian government debt alone is equivalent to the entire German GDP.

This implies that anyone expecting a country's downgrade would not be selling only government securities but also shares of its banks. This, in turn, increases the cost of capital for the banks making them even weaker. Moreover, even stronger banks — who see their own share prices falling and credit-default spreads widening — react by refusing to provide the other banks with interbank liquidity. The breakdown in the interbank market, in turn, leads to a breakdown of the credit circuit, which kills growth.

This was the dynamic that led to the severe recession experienced after the Lehman bankruptcy showed. During the worst crisis moments of 2011 capital markets were anticipating the potential for a doomsday scenario with the economy going abruptly into a severe recession as the interbank market breaks down and the public debt problems are expected to grow further. These expectations might well have materialised had the ECB not addressed the issue in December of 2011 with the announcement of its new facility providing very long-term funding (3 years) coupled with easier collateral rules (the LTRO). The breakdown of the interbank market was averted.

What needs to be done?

In times of crisis only a massive infusion of liquidity can prevent a disaster. How could this be ensured? Given the structure of the ESM, the solution cannot be a massive increase in its size. Rather, the ESM could simply be registered as a (special) bank or 'monetary financial institution' in Luxembourg with access to refinancing by the ECB in a case of emergency.

The ESM, which we would prefer to call the European Monetary Fund (EMF), would then have access to ECB funding on the same condition as 'normal' banks, for which the Central Bank acts as a lender of last resort.

Adjustment funding and help for debt restructuring would be carried out by the EMF with the financial endowment already decided. Smaller secondary market intervention in case of limited liquidity gaps could be funded in the same way. However, in case of a big liquidity crunch, the EMF could access ECB facilities by

borrowing against the government bonds it is purchasing as collateral. Assuming that the ECB insists on the top quality of the assets it takes for collateral — as for instance assured by a high rating — it would ensure that it only lends in case of a liquidity crunch and not when a country suffers from insolvency. The decision to intervene to buy national government bonds would be taken by the EMF, based on expert assessments and under the supervision by finance ministers and not, as de facto at present, by the ECB, whose task is not to determine fiscal policy in specific countries, but to look after price and financial stability for the euro area as a whole.

Moreover, the EMF would also be the proper place to formulate and monitor the conditionality which would have to go hand in hand with any EMF intervention, including buying bonds on the secondary markets. At present this is done implicitly by the ECB, which uses its SMP to pressure the Italian government into reforms and fiscal adjustment. However, there is no representation of the European taxpayers on the Governing Council of the ECB, which might have a tendency to be too much concerned about instability in financial markets and have too little regard to the interests of taxpayers.

The ECB would still be able to control liquidity developments for the entire euro area because once financial markets have returned to normal it could simply stop its policy of full allotment. At this point any refinancing by the EMF would simply crowd out financing to other banks and thus not increase area-wide liquidity.

Backstopping the EFSF with the ECB — i.e. creating an EMF — would have the advantage over the current mess that it leaves the management of public debt problems in the hand of the experts and finance ministries, but it provides them with the liquidity backstop that is needed when there is a generalised breakdown of confidence and liquidity. In a crisis the fundamental problem of banks and governments is always one of liquidity. This is exactly when a lender of last resort is most needed.

The ECB is the only institution which can provide the required 'lending of last resort' quickly and in convincing quantity. It would of course be much better if the ECB did not have to 'bail out' the European rescue mechanism, but in this case one has to choose

between two evils. Even a massive increase in the ECB's balance sheet (which, if the US experience is any guide, will not lead to inflation) constitutes a lesser evil compared to a breakdown of the euro-zone financial system.

Conclusions: no silver bullet

Bringing EMU back to safe ground will of course only succeed if first deficits are reduced substantially and then debt levels (as a percentage of GDP) are brought down slowly as well. The financial crisis has vividly demonstrated that excessive debt loads, especially if combined with large deficits, cannot be financed in anything but the extremely benign markets that prevailed between 2000 and 2007. Countries that accumulate excessive debt will sooner or later experience their 'Minsky moment', when the rolling of this debt becomes impossible. For a stable EMU a long-term movement towards lower debt levels is a '*condicio sine qua non*'. The mechanisms to achieve this have now been considerably strengthened through the tightening of the rules of the Stability Pact, the reverse qualified voting mechanism (under which a proposal by the Commission to sanction a country in excessive deficit is taken to be approved unless it is overruled by a qualified majority) and the so-called fiscal compact, which forces member countries to adopt essentially balanced budget rules at the national level.

However, debt reduction takes a very long time, hence the need for an effective crisis management mechanism along the lines sketched above. One without a mechanism with which to forestall liquidity crisis means that the other mechanisms will not be able to work, and EMU will fail.

Our proposal will certainly not satisfy the purists who regard EMU as the rebirth of the gold standard. For the purists, our proposal amounts to monetary financing of government debt behind a thin veil. We would answer them that in the real world of today a pure gold-standard-like arrangement will not work. In today's environment, the central bank needs to look after financial stability, which means that it needs to assume the role of a lender of last resort to banks and — because of the bank–government–debt nexus

described above — also governments. The question is not whether, but how this role is performed.

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IV.

Reinforced fiscal and macroeconomic coordination and surveillance: economic aspects

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Reinforced fiscal and macroeconomic **coordination** and surveillance: economic aspects



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This session is devoted to fiscal and macroeconomic coordination and surveillance. These are clearly very important questions. Let me start by recognising that the macroeconomic imbalances between eurozone members have had a strong impact on the private and public debt, and on the fiscal trouble that Member States are suffering. We have to tackle these underlying economic imbalances. Recognising this, national governments and European institutions put forward several instruments to reinforce the fiscal and macroeconomic coordination and economic governance of the eurozone.

Our panellists today should try to focus on the following issues: how these measures will effectively contribute to narrowing the macroeconomic imbalances; which are the strengths and the weaknesses of the chosen measures, in particular the European semester and the recently decided package; how they can be implemented in the most efficient way; how the fiscal discipline can endanger the required recovery; and which

reforms can push growth and employment.

There is a tension between austerity and growth which has to be taken into account when we talk about macroeconomic coordination. The general role of the European Central Bank has already been taken into consideration, but the role of the European Central Bank as more active in tackling the crisis also needs to be examined.

Finally, something which cannot be forgotten is the question of fiscal and tax harmonisation. This has to be taken into consideration when we talk about macroeconomic coordination. Macroeconomic coordination is also related to the fiscal part of the public budget. These are the key questions which I am sure our panellists will address.

The Greek tragedy



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The idea is that we learn something from this Greek tragedy. As you know, a Greek tragedy has many parts. When it builds up, at the end is the catharsis. We are now in that stage, but there was a time when every player was doing his or her part and trying to do the best that they could. Of course we, the chorus, the intellectual elite, were saying no, this is going wrong. You saw the process in the last 2 years through which the whole tragedy escalated and was uncontrollable.

First, let me ask: could we have recognised this process 10 or 12 years ago? That is an interesting question and the answer is yes, not only with the benefit of hindsight but also *ex ante*. When we look at these current account imbalances, we can already see how they build up. Of course, the northern part of Germany has surpluses and the southern part has deficits. This went on for a long time without any thinking about corrective mechanisms. Of course, the exchange rate was not available anymore, so then you have to do it with inflation, with

nominal wage differences. That is also interesting because this building up of the process is typically also visible in the net position, for example that of Greece with the assets and liabilities.

Do you know how the net position of Greece deteriorated over the last 10 years? Nothing was done, nothing was considered to be urgent, and of course, there was also the role of the ratings agencies. If you look to the ratings before the credit crunch in 2008 there were almost no differences in perceived default risk between the countries. I am currently writing a briefing paper for

the European Parliament committee about the monetary dialogue with the ECB. The ratings agencies were sleeping before the crisis and are now they are off-shooting after the crisis. They are just following the spreads and they do not have so called objective criteria with which to measure the default risk premium of certain countries. Anyhow, this was still a development which was foreseeable, and also available for everybody to say, well, this is getting out of hand.

Take Portugal: more or less the same picture; assets and liabilities in that position. You see a deterioration which is not as bad as in the case of Greece, but I would say that it has typically been a worrying situation from 2000 onwards. If we look at the demarcation line where EMU started, you see that the process of imbalances increased. Apparently we then had mechanisms to rebalance that and normally there are two mechanisms which can do so. On the one hand you have wage flexibility, nominal wage flexibility and real wage flexibility. On the other hand, which is much more difficult in Europe, you have labour mobility, not only of the low segment or the high segment (the professionals), but of all the people. You know what happens in the US if you become unemployed? You lose your job, you lose your house and sometimes you lose your partner. Well, that is a good incentive to move from the west coast to the east and/or the other way around.

This is typically something which we have not thought about and actually, if you look to the discussions amongst economists and political scientists before EMU was set up, everybody said that we should care about labour mobility and wage flexibility as adjustment mechanisms. Ireland is a special case. The net position of Ireland is, of course, not that bad, but do you know what happened with Ireland? After the credit crunch, after the Lehman moment, Ireland, which was overbanked, took on all the problems of the banking system. First, the deposit of the insurance guarantee. It was one of the first countries which raised the limit to 100 000, like Greece by the way, and then ultimately Germany followed. Second, they took the debt in the housing market over from the banks, and thereby the banking problem became a sovereign debt problem. And now, of course, an interesting phenomenon: why were these countries driven to engage in debt, especially the southern

countries? This is not surprising because we have one interest rate in the eurozone, but it does not mean that we have one inflation rate. All the regions have different inflation rates. If the nominal wage demands are higher than productivity developments then there are high inflation rates in those regions of the eurozone.

So what actually happened, in some southern countries, is that the nominal wage development was higher than productivity. This is because these economies, especially the Greek economy but also the Portuguese economy, were sheltered. They were part of the common currency but they were never a real part of the common market and did not have the discipline which the internal market enforces. And thereby, the nominal wage demands exceeded the productivity development, and that means inflation. What happens then, if you have the same interest rate, short or long-term interest rate, and you have high inflation — you get negative real interest rates. What does it mean if you have a negative real interest rate, like now? It means that you are stimulated to engage debt, privately or publicly, and not to save. So we promoted that in those countries, privately and publicly, by having negative real interest rates for a long time. All of these things were part of the process of having no adjustment mechanisms.

Then if we look to the real site, the real effective exchange rate which is the competitive position of a country, we know, of course, that the competitive position of the southern countries also deteriorated gradually. Germany was a country which, I would say, redesigned its institutions in the last 10 years and became more competitive. In the case of the more northern countries, such as the Netherlands and Denmark, what you see is that the competitive position of these countries was deteriorating gradually. Therefore, they were not able to have enough earning capacity and growth potential. This growth potential was also harmed by the fact that the economies were sheltered and they were not fully part of the internal market. As a result they did not enforce higher productivity, for example in the exporting sectors but also in sectors such as the service industry.

The last slides here are quite simple, showing the debt to GDP ratios. Of course we can also go to the typical Greek case, and now in October 2011 we have a forecast again for the world economic

outlook. That means, of course, that the perspective for Greece in terms of debt will deteriorate further and thereby the refinancing becomes much more difficult. Every half year we have a kind of adjustment to a higher level, and that also makes these problems worsen because it's a solvency problem. There was a liquidity problem at the start, but it became a solvency problem. The same happens with other southern countries; Italy is a typical case. It is a liquidity problem, not a solvency problem, but a liquidity problem can become a solvency problem if we wait too long.

Now, the last thing is the unemployment rates. Spain has the worst unemployment rate, not only general unemployment but especially youth unemployment, which has stood at 40 % for a long time. 40 % youth unemployment, what does that do for your social cohesion? I would say it's completely unacceptable, and we have to do everything we can to address it. Some of things we could use, for example, are the Structural Funds, and the Cohesion Funds, and the European investment banks. For example if you know that the solvency ratio for the European Investment Bank is 27 %, that's quite a lot; there is some firepower there too.

However, let me go to the solutions. There was a big debate in the Netherlands about this, and also in Germany. Germany is a special case because of the Bundesverfassungsgericht, the supreme court, which sets very strict conditions for increasing the EFSF. The Deutsche Bundesbank must be fully involved in every decision, which makes Frau Merkel's position very difficult, but the real reason why the crisis deteriorated is the non-functioning of the French–German axis. If you look to the past, the French–German axis was always very effective in the last decades. If we look to the deal of Dauphil, but also to the accord of 26 October, we see that there are no real solutions. Every time it is behind the curve, and the real solution is very simple.

First, implement, like President Draghi of the ECB says, the accord of 26 October, and do it as quickly as possible. The EFSF does not have enough firepower, which means that you have to put your money where your mouth is and increase the rescue fund. How can you expect China or Brazil to put their money there, when you're not prepared to put your own money there? Then we come to the

issue of leveraging. Klaus Regling, the head of the EFSF, has already admitted that it is strange. How can you leverage without putting real guarantees and real money there? The leveraging is not automatic; you cannot have your cake and eat it. If you take 20 % of the part of the risk, the marginal 20 % or the 25 %, then the risks of this 20 or 25 % increase. So one thing is to increase the emergency fund right away, and implement it as soon as possible.

Second, the ECB must play a role. It's very difficult for the ECB in this time frame when, for example, the French President says that we should use the ECB for monetary finance and quantitative easing, like the Fed or the Bank of England does. The ECB has its statutes and it has to comply with them. There is only one thing which the ECB must do, and that is also in the statutes and the treaty. The ECB is responsible for financial stability. That means that ECB has to play a role in the secondary market now, with the security markets programme. It is on the edge of its mandate, but it is allowed. It is allowed as long as the ECB preserves financial stability without jeopardising price stability. We are going to a recession, so the risks of price stability are limited, but this is the condition, the only condition the ECB will hold to. That means that the ECB will not engage quantitative easing, like the Federal Reserve system does, or the Bank of England, but the ECB can, of course, play a role in buying on the secondary markets, and thereby help to reduce the spreads. It can only do this if there is the perspective that it is temporary and that the ECB is able to sterilise the money-market effect.

Lastly, what we cannot have now is a disagreement between the Heads of State or Government in Europe, which we have on a regular basis. Secondly, we cannot have a disagreement between the Heads of State or Government with the ECB on the other side. That is very disruptive for the financial markets, so, there is only one solution — a common declaration of the European Council and the ECB, saying that they agree about this solution.

As long as there is a public fight, a public debate between some Heads of State or Government and the ECB on the other side, the problem will escalate in the financial markets because of increasing uncertainty. There comes a moment when even I, as a true European, am not certain that the eurozone will survive.

Towards a euro fiscal union: **reinforced** fiscal and macroeconomic coordination and surveillance is not enough

Introduction

The first decade of euro integration was successful as low inflation rates, increasing financial market integration and higher employment were achieved (European Commission, 2008; ECB, 2008; Deutsche Bundesbank, 2008); and there was interest rate convergence across countries, namely at the low level of German and French government bonds.

In the EU traditionally there was rather limited fiscal policy coordination and even during the transatlantic crisis there was no strong coordination, as only the informal institution of the Council of Euro Finance Ministers exists to discuss this topic. An implicit tool of fiscal policy coordination was the Stability and Growth Pact that was supposed to avoid countries' deficit-GDP ratios from exceeding 3 % in the euro area (unless there was a severe recession) and also assumed that countries would engage in bringing excessive debt-GDP ratios towards the maximum of 60 % in the long run. The fiscal compact adopted at the EU summit of December 2011 — a new set of stricter fiscal rules to be adopted by 25 EU countries within a separate treaty — is not likely to solve the credibility problems. The litmus test will come when the first excessive deficit cases come up: if no country takes the 'sinner' to the European



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Court of Justice the credibility of the euro area will be shattered again. Only the creation of a euro fiscal union could overcome the problem of fiscal policy coordination.

The background of the euro crisis

Belgium and Italy were starter countries with debt–GDP levels above 100 % in 1999 and Greece also joined the euro club with more than 100 %. However, these countries (including Ireland) showed considerable success in reducing debt–GDP ratios in the period 2001–07 (Italy and Belgium also in the run-up to the launch of the euro), but after 2008 the situation deteriorated dramatically in many euro countries. The European Commission (2011) in its report on public finances showed that the debt–GDP ratio increased by 22 % for the euro area in the period 2007–12; the rise in the EU as a whole was 24 %. About half of the increase is due to automatic stabilisers. The debt–GDP ratio of the 17 euro countries is expected to reach 89 % in 2012, which is about 5 percentage points higher than in the EU-27 group. The main driver behind the rise of debt–GDP ratios is the transatlantic banking crisis of 2007–09, rather than a special sovereign debt crisis or a general tendency towards excessive deficits. This holds despite the fact that many observers referred to the Greek debt crisis — which indeed is a special case of a national sovereign debt crisis — and concluded that together with the debt problems visible in Ireland and Portugal (and later in Spain and Italy) the euro area is facing a general sovereign debt crisis. This, however, is an inadequate view of the problems; for most observers the debt dynamics of EU countries are rather opaque.

There is no doubt that Ireland's problems are almost completely related to the transatlantic banking crisis and the associated special Irish banking crisis whose dynamics are rooted mainly in Dublin, namely in a government which failed for years to implement any decent standard of prudential supervision. Portugal fell victim to well-known structural problems in improving its international competitiveness. Years with high double deficits (in the current account and in the government budget constraint) implied not only that the debt–GDP ratio was increasing but the role of foreign indebtedness was growing over an extended period in a rather dangerous way.

In 2011 there emerged a growing perception of a rather general over-indebtedness of countries in the eurozone — sometimes even interpreted as a fully fledged euro area crisis. This perception is not related to hard facts, but rather to destabilising crisis management, contagion and a Greek political crime respectively.

- The EU/euro summits have failed to push Greece towards broad privatisation — a country where government assets according to the IMF (2010) exceed government debts by at least EUR 30 billion has received massive rescue loans from euro partner countries (EUR 110 billion in May 2010, another EUR 130 billion in October 2011). The doubtful wisdom of the summits brought haircuts on private creditors of 21 % during the Brussels meeting of July 21 and even 50 % in late October.
- The debt shock of Greece — a ‘political fraud’ — took place in 2009 right before the elections when the conservative government made strange decisions implying an incredible deficit–GDP ratio of 15 % for that year. One should note that a 15 % deficit–GDP ratio implies — given the fact that typically a reduction of only 3 percentage points per year is possible — that within 5 years the debt–GDP ratio will increase by about 45 %; thus such an increase is totally irresponsible for a country whose debt–GDP ratio is already at 110 %.
- At the same time one may argue that the intensity of contagion observed in the case of a small country such as an over indebted Greece is surprisingly strong (see the subsequent analysis). That a political crime such as a national deficit–GDP ratio of 15 % neither triggered sharp public admonishment from the side of the European Commission or sharp sanction is quite disappointing and indeed very worrying; and given the very sobering experience of a non-functional Stability and Growth Pact one cannot hope to deter other potentially irresponsible governments from substantially exceeding the maximum deficit ratio of 3 %.

When the risk premiums shot up after the 2008 failure of Lehman Brothers, it was clear that countries with high debt–GDP ratios and high external indebtedness were bound to face serious problems. As this author wrote in a book published in early 2009, whose manuscript was finished in late October 2008:

The eurozone could face serious problems if the risk premiums for such countries as Greece, Italy, Spain or Portugal should increase. Considering that Greece and Italy face high debt–GDP ratios and high deficits plus high foreign indebtedness one cannot rule out that during a temporary accentuation of the global financial crisis it will no longer be possible for these countries to get refinancing from markets. In such a situation, the no-bailout clause of the Maastricht Treaty should not be applied if indeed a country such as Greece should face serious problems in the aftermath of impulses from the US banking crisis. Rather, member countries of the eurozone should support member countries with refinancing problems in the spirit of solidarity and responsibility. Similar to the massive guarantees of EU countries for their respective banks, they should come up with guarantee packages for countries with serious refinancing problems. It should also be considered that the European Investment Bank — an EU institution — also gives particular guarantees for several years. It would not be adequate during a global financial crisis to apply the rules of the Maastricht Treaty established for the case of a normal world. This, however, is not to say that EU countries should excuse lax fiscal policies and high deficit–GDP ratios as a new loose fiscal framework. Given the fact that monetary integration and monetary union, respectively, have proven to be useful in the transatlantic crisis, it would be quite insensible to undermine economic and monetary union through an overly strict interpretation of the Maastricht Treaty.

(Translated from Welfens, 2009, pp. 158–159).

While the strong recession of 2008–09 could explain why euro countries resorted to expansionary fiscal policy in that period, it is absolutely unclear why deficit–GDP ratios remained very high and above the 3 % deficit–GDP ratio in Spain, France and Italy even in 2010 — as well as in the UK and in the US (with the latter two countries moving towards 10 % of GDP).

The Greek crisis of 2010/2011 raised several issues.

- How could a government manage to deceive the European Commission so bluntly as in the case of Greece where the

government under the Nea Dimocratia indicated (in mid 2009) that the deficit–GDP ratio would be about 5 % while in reality it turned out to be 15 %, as became clear in 2010? (The type of political fraud which has occurred in 2009 in Greece cannot be avoided by stricter deficit rules because once it has happened it is too late!)

- Why did the European Commission not immediately impose sanctions on Greece for failure to deliver correct data? Part of the answer is that imposing sanctions on a country that already is facing a 110 % debt–GDP ratio is difficult; part of the answer is that the European Council could block sanctions for even extreme violations of the pact.
- To what extent is there a problem of contagion or herding behaviour in the euro area? Empirical analysis by Missio/Watzka (2011) provides evidence for contagion and clearly indicates that Greek debt problems affect Belgium, Portugal, Spain and Italy, and that the downward rating of Greece also negatively affects Portugal and Spain; Greek and Spanish ratings depend on each other. Such contagion effects might then justify the use of a euro rescue fund to stabilise Belgium, Portugal, Spain and Italy. ECB intervention could also be justified with reference to serious contagion problems. Corsetti et al. (2005; 2010) define contagion as a structural break in the transmission mechanism of shocks and Missio/Watzka (2011) follow this approach. However, one may add with specific reference to Greece that part of contagion problems is typically also one of small crisis countries affecting relatively large economies, which is counter to the implications of standard small-country models in the literature (so there should be no effect of Greece on Italy or Spain; e.g. with respect to Italy, trade and investment links are too small to explain that an economic crisis in Greece would affect Italy). Since contagion problems of Greece with respect to Italy, Portugal and Spain (plus Belgium) are obvious and significant it is clear that any haircut for Greece will negatively affect the valuation of Italian, Spanish and Portuguese bonds. Rising interest rates in Italy, Spain and Portugal could be the immediate consequence of a haircut for private creditors of Greece.
- Surveillance of economic policy should be a natural element of supranational policy in all euro countries and it is indeed

part of the EU's policy approach. However, surveillance is to a large extent effectively delegated to the IMF, which is responsible for its standard Article IV consultations every year and for reports on financial stability (financial sector assessment programme — FSAP). The EU comes up, however, with its own regular reporting, but few consequences are visible from even very critical reports, for example on Italy with respect to low growth rates (the Commission/DG Economic and Financial Affairs has published lengthy reports on growth issues, hence it is not true that there is a lack of analytical material on the weak points of Italy's growth performance).

- Fiscal policy coordination through the Stability and Growth Pact has turned out to be largely ineffective, as the pact has been breached more than 60 times in the first decade and no country ever had to pay a fine despite several countries showing strong and sustained violations of the pact. The Greek government was, however, able to get a first rescue package in May 2010 and a second one in autumn 2011 — each time with minimal promises in the field of privatisation. The first rescue package was given without much consideration of the issue of privatisation in Greece. The second rescue package brought a lukewarm promise from Greece to privatise EUR 50 billion by 2015, which is less than one seventh of overall government assets as estimated by the IMF (2010) in December 2010.

Euro Plus Pact

On April 20 2011 the European Council issued a statement on the Euro Plus Pact, according to which euro area member countries plus several other EU countries want to strengthen economic governance in order to achieve enhanced fiscal discipline and to avoid critical macroeconomic imbalances. This includes emphasis on a reform of the Stability and Growth Pact aiming at a better surveillance of fiscal policies. There is, however, a broad analytical lack with respect to the topic of macroeconomic imbalances. It is absolutely unclear which analytical basis is taken as the basis of selected indicators of macroeconomic imbalances.

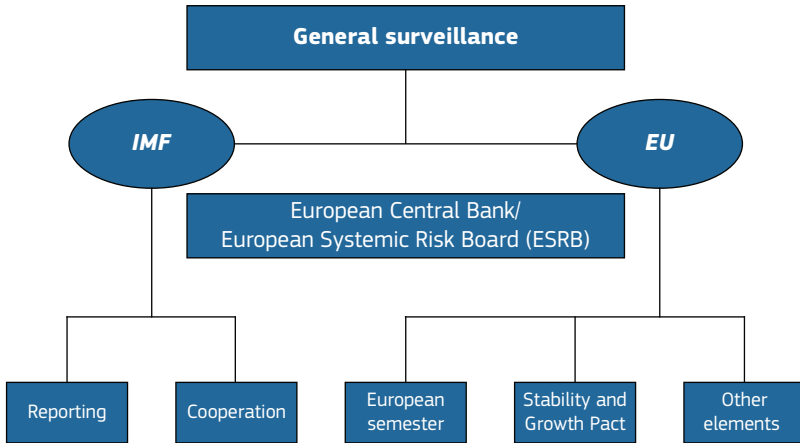
Economic and monetary union is likely to fall apart if the key problems observed in the EU continue.

- As regards economic and monetary union and the functioning of global capital markets there is a lack of understanding as to how the systems work, both on the side of the European Council and (it seems to a lesser degree) on the side of the European Commission.
- There seems to be a broad political view according to which agreement of a large number of countries on certain measures implies that the measures chosen are adequate. This, however, is an irrational approach. The adequacy of any measures suggested and taken depends on a sound analysis of the problems at hand. Such analysis is missing (for example, in the case of the Greek debt crisis), and this is the main reason why the Greek debt crisis remains unsolved 2 years after the outbreak in late 2009. Well-known economists have contributed with poor policy advice — calling for high haircuts and ignoring key contagion aspects — to a partly dangerous policy of the European Council in the fields of the Greek debt crisis and the euro crisis respectively.
- If the euro area's leaders should be unwilling to discuss critical analysis of their strategy and policy, the EU will most likely fail this historical challenge.

Macroeconomic surveillance

Surveillance refers to an indicator-based/qualitative analysis of subsystems or the whole economic system of a country, where the goal is to identify critical system dynamics that could cause serious or persistent problems in the country under consideration, as well as in other countries. In a European context one may point out that general surveillance is more or less an orchestrated effort of the IMF, the European Systemic Risk Board (led by the ECB) and the EU — see the subsequent exhibit.

In the field of surveillance, for example, one may rely on the IMF's Article IV reports and the updates on the financial sector assessment programme, as well as specific cooperation between the IMF and a programme country; that is a country getting funds from the IMF. The EU has so far relied on the Stability and Growth Pact and the excessive deficit procedure in the euro area. However, the pact could not really be enforced. The idea to get earlier access

Figure 1: General surveillance

to budget planning data, namely within the European semester, is a useful element. However, this does not help in the case of outright deficit fraud, as in the case of Greece in 2009.

Starting in 2011 the Commission's new macroeconomic surveillance approach is about a broad set of indicators. Basically the objectives are to look at:

- The financial stability of the economy, where the European Systemic Risk Board is of key importance. The working of this new institution is still rather unclear, but the role of the ECB could become doubtful if the ECB's buying of government bonds of highly indebted countries cannot be explained within a consistent strategy: The ECB as part of the European Systemic Risk Board would have to critically assess its own interventions — and this is not a convincing role.
- Fiscal policy developments within the framework of the Stability and Growth Pact, and procedural development within the European semester. There is an unsolved key issue here, namely how governments could accept any public criticism or even a fine. The only way to impose a fine would be an automatic mechanism, for example, a country which has not achieved at least a budget surplus of 0.5 % of GDP

automatically pays 0.25 % of GDP to the European Investment Bank. Each country would have to make an advance deposit so that no discussion could occur whether or not the country really wants to pay the fine or not. So far no real automatic regime has been installed and there are no sanctions considered for a country that is not achieving a surplus in a boom situation. This, however, is — according to the view adopted here — of paramount importance for shifting the deficit path upwards. From a political economy perspective one could expect that a fine in a surplus situation will be paid; to put it differently, the resistance will not be as strong as in a crisis situation in which a fine would raise any existing deficit.

- The excessive imbalance procedure, which means to look at the external imbalance and the internal imbalance. There is no consistent approach by the EU. From a theoretical perspective, one may point out that a poor country normally has a current account deficit over many years (since capital flows from rich countries to poor countries if catching-up is to take place), but this deficit should be financed mainly by foreign direct investment inflows. Greece's main problem has been that the country had only about 1 % of GDP as FDI inflows in the long run. This is so low that it is an indicator that Greece has certain problems. Given the global expansion of China and other Asian countries one might want to take a critical look at the dynamics of the composition of trade: Poor countries which are catching up in terms of per capita income should raise export unit values over time as more high-quality goods and services are exported; better quality of export products is typically associated with the production of more knowledge-intensive and capital-intensive goods. Borbely (2006) has shown that Greece and Portugal faced considerable problems in the 1990s in certain industries when these countries were compared to eastern European EU accession countries.
- The Europe 2020 strategy, which puts the focus on sustainable growth and cohesion. Here the Commission has put a focus on green growth, innovation and cohesion. However, the results from the Lisbon agenda 2010 were rather sobering (ECB, 2008) and there could be similar problems with the Europe 2020 strategy. It is disappointing that the EU Lisbon agenda 2010 placed so much emphasis on improving

international competitiveness while Greece and Portugal continued with a policy leading to sustained high current account deficits. In the case of Greece the very low foreign direct investment inflows should have been taken as a signal that such high deficits were not sustainable.

As regards the six macroeconomic indicators selected by the Commission, it is absolutely unclear why the current account balance of a country should be a matter of concern, unless there is a major current account deficit of the euro area and this deficit could be traced back, to a large extent, to the country considered. However, the net external position could be a case for concern, namely to the extent that it is high relative to GDP and could trigger a wave of non-confidence by investors from abroad. The real effective exchange rate based on unit labour costs is of some interest in the case of a critically negative net external position. In addition, the public sector debt–GDP ratio is potentially a concern. Less convincing is that government should be much concerned about real house price increases unless they occur in a dramatic way in a short time period. This was the case in Ireland, but the main underlying problem of Ireland was that its government had not implemented any serious prudential supervision since the beginning of the 21st century and as a consequence excessive lending in the real estate sector in Ireland occurred, which in turn caused extreme relative price increases. It is also unclear why the private sector debt–GDP ratio should be a particular cause of concern since one should assume that private households themselves will know — along with advice from the respective banks — what is adequate borrowing. Rather one might consider that the European Systemic Risk Council should take a look at the ratio of private sector debt to GDP and this council's report could feed into the decisions of the Commission.

From a theoretical point of view one may raise several questions.

- To what extent is the overall euro current account position relevant for assessing the vulnerability of individual countries' debt–GDP positions? The answer, surprisingly, is that as long as there are no supranational eurobonds the external aggregate euro area position is irrelevant — it almost only matters which positions individual member countries have. In a monetary

union without fiscal union even a small member country can destabilise the whole monetary union, namely through contagion effects.

- If the eurozone has no extreme sustained current account deficit, intra-euro area deficits should not matter, unless the national debt–GDP ratio exceeds, for example, 80 %. National current account deficits which are financed within the euro single market should not be of concern, since an intra-euro area current account deficit simply means that people from euro area partner countries increase the share of real estate, stocks or bonds from the internal deficit country; if the debt–GDP ratio exceeds the assumed critical point of 80 % there is some risk that, with the debt–GDP ratio further increasing under adverse effects, there could be an international confidence crisis which first drives up the interest rate of the respective country, and which through contagion is undermining the overall stability of the euro area and the EU respectively. The intra-euro indebtedness would no longer matter much once there were supranational eurobonds.
- The emission of supranational eurobonds should be related to the creation of a euro area government and a euro parliament which would elect the government; only this euro government should be allowed to place eurobonds in the market and the ECB would intervene in the future only in supranational bonds markets.

Approach of the Commission

The European Commission apparently interprets the sovereign debt crisis of many euro countries as largely standing for macroeconomic imbalances, and thus presented on 29 September 2010 a proposal for a regulation of the European Parliament and of the Council on the prevention and correction of macroeconomic imbalances (COM(2010) 527 final): The Commission writes (p. 2):

The emergence of large macroeconomic imbalances, including wide and persistent divergences in competitiveness trends, proved highly damaging to the European Union, and in particular to the euro, when the crisis struck. In the years preceding the crisis, low financing costs fuelled misallocation of

resources, often to less productive uses, feeding unsustainable levels of consumption, housing bubbles and accumulation of external and internal debt in some Member States. It is therefore important to develop a new structured procedure for prevention and correction of adverse macroeconomic imbalances in every Member State.

In its communication and report on 'EMU@10: successes and challenges after 10 years of economic and monetary union' the Commission proposed a broad policy agenda with the aim of improving the functioning of EMU. It stressed, in particular, the need to broaden economic surveillance in order to detect and address macroeconomic imbalances at an early stage. Enhanced surveillance was seen as particularly warranted in the areas of external competitiveness and current account balances, where noticeable divergences between Member States had emerged since the launch of the euro. In order to address these challenges, in July 2008 the Euro Group agreed to initiate a regular review of developments in competitiveness within the euro area that has been fruitful.

Europe 2020 sets out an ambitious and comprehensive strategy towards smart sustainable and inclusive growth for the EU economy. Against the background of the crisis it sets a new focus on addressing Europe's weaknesses in the surveillance of macro-financial and structural challenges. Taking account of the deep economic and financial inter-linkages within the euro area and their impact on the single currency, Europe 2020 calls for the development of a specific policy framework for the euro area to tackle broader macroeconomic imbalances. A mechanism embedded in legislation monitoring sources of macroeconomic imbalances and ensuring appropriate corrective action when necessary is required from that perspective. The necessary linkage between preventive and corrective action is crucial to avoid painful economic adjustment when imbalances grow out of control.

The Commission has developed a complex system for an excessive imbalance procedure (EIP), which is based on a scoreboard backed up by judgmental analysis. The European Commission has

finally adopted a new set of complex criteria to implement better macroeconomic surveillance. While the Commission certainly has good intentions, the proposed complex set of indicators is more confusing than helpful, and some points emphasised by the Commission are difficult to understand.

New approach: European semester and scoreboard

The European Commission has suggested a new tool for the preventive monitoring of economic policies of EU member countries, particularly concerning fiscal policy. The so-called European semester is assumed to bring enhanced policy coordination through the European Commission. The procedure of the European semester can be summarised briefly as follows.

- In March of each year the European Council will identify the policy priorities, namely on the basis of a report from the European Commission (the annual growth survey published in January). Based on this, recommendations will be derived for budgetary policy and economic policy of EU Member States.
- In April the Member States will submit their medium-term budgetary plans and economic policy strategy to the European Commission.
- In June and July the European Council and the Council of Ministers will issue country-specific proposals and recommendations on general economic policies and on budget policy. The European Commission's annual growth survey for the subsequent year will assess the implementation progress of these recommendations.

The European Commission has prepared and published several proposals for a scoreboard in the field of macroeconomic policy. Of the indicators proposed for the macroeconomic scoreboard, only the current account balance is useful for covering the dynamics of external indebtedness and the government debt–GDP ratio as a sensitive indicator showing how sustainable current fiscal policies are. Real house price increases should always be monitored by economic policymakers but it is quite doubtful to assume that real house price increases stand for macroeconomic imbalances; possibly, if strong nominal (and real house) price increases should occur,

regional governments as well as national governments could try to encourage construction building by reducing transaction costs and selling part of the government's land to prospective investors.

The surveillance mechanism consists of two key elements.

- The European Commission will monitor the scoreboard indicators: this is stage I of the new European semester approach. If specific threshold limits of the scoreboard indicators are reached — for example, the upper quartile or the lower quartile of the statistical distribution of each variable are exceeded or not achieved — closer analysis by national economic policymakers should clarify whether or not the macroeconomic imbalances are damaging.
- Stage II will start an excessive imbalance procedure and this should stimulate countries to change their respective policies.

Based on this set of indicators the European Commission then wants to establish a multipronged surveillance mechanism.

Conclusions

Surveillance is the regular analysis of macroeconomic variables and key policy measures in countries. How good is surveillance, which in practice consists of analytical papers written by teams from the IMF, the EU or other international organisations or a mixture of organisations (e.g. the Troika group, which consists of the IMF, the ECB and the EU)? Surveillance is useful for creating more transparency and for generating pressure for timely economic reforms; however, a system of surveillance should be professionally organised and this means that there should be external random evaluation of the reports of major international organisations. This however is not happening. Subsequently, we take a brief look at some IMF surveillance activities, which are largely believed to be the cream of the analytical crop.

With respect to Greece it is noteworthy that the IMF's Article 4 consultation report of May 2008 was quite optimistic that the country could continue output growth and achieve a balanced budget in 2010 — the official goal of government. However, in hindsight it is well known that Greece's deficit-GDP ratio had already exploded

in 2009. Footnote 10 of the IMF Article 4 report of 2007 noted (IMF, 2008, p.16): 'As Figure 3 shows, if real GDP growth dropped to 2 % on average, the public debt-to-GDP ratio would rise to 98 % by 2013, compared with a decline to 72 % under the baseline scenario.' The expected debt-GDP ratio for 2013 is in 2011, however, close to 160 %. It is surprising how fast the Greek debt-GDP developments got out of control.

At the bottom line it is obvious that only a shift towards a euro political union can bring long-term stability for monetary integration in the EU (Welfens, 2012). Government expenditures should be shifted from the national to the supranational level, which should get about 4 % of the euro area GDP so that fiscal policy can be shifted exclusively to the supranational policy layer; expenditures on infrastructure, defence and promotion of research and development should be key elements of a much larger role for the supranational policy layer. A euro area parliament should elect a supranational government and this could then also place true eurobonds in international capital markets. The present crisis approach of European policy organised on the basis of EU/euro summits is inadequate, and brings the risk that the role of the European Commission is further undermined, and that the strongly visible role of Germany and France contributes to resistance of euro partner countries and could indeed contribute to renewed nationalism in Europe.

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Concluding remarks

From a journalist's point of view who has heard all this, it is not as negative as has been mentioned. There are also some positive elements, in that every one of you has a solution for the problem. Unfortunately they are very different solutions and there was not much agreement on some points. The more long term the perspectives become, the less agreement there seems to be, at least the long-term perspectives seemed very different from what I heard. In the short term I think there is some kind of agreement that the European Central Bank should play its active role in accordance with its mandate and there is some chance to buy more time.

When it comes to the real key questions of real, long-term reforms, I have heard many different things. I have heard from Elisa Ferreira that we have to reinforce ownership, that it is not a question of simplicity, that we have to give each country the chance to elaborate a realistic solution which works in this country. On the other hand, Mr Welfens remembered that we need some rule-based orientation in the way that we have to go to court if some countries do not play by the rules. There were some differences between these two positions. From another perspective, Laurence Boone told us that the ECB is not the permanent solution and the eurobond in its current form is not the permanent solution. As I understand, she was in favour of fiscal integration. Mr Eijffinger's contribution offered us somewhat of a Nike slogan: 'Just do it'. We found some solutions in October, so let's go on to implement, deliver and try to increase the EFSF, and try to give the ECB the chance to play an active role.



Detlef Fechtner

EU correspondent of Börsen-Zeitung

I will conclude with one experience myself. I come from Vienna and I was talking to trade unionists about the same issue. This will directly link to the next session because all of the proposals which were made here, even the fiscal integration, even increasing the EFSF, and asking the Member States to take more financial responsibility, are hardly opposed when you talk to common people. Therefore, the question we have left for the next session is how to translate this into politics and bring Europeans with us along the way, because all of these splendid proposals are very difficult to implement in the political arena.

V.

Strengthening the governance of the euro area: political and institutional aspects

José-Maria Gil-Robles

Nikolaos Chountis

Amy Verdun

José Maria de Areilza

Pierre Lemoine

Introductory remarks



José-Maria Gil-Robles

Former President of the European Parliament; President of the European Council for the Jean Monnet programme; Jean Monnet Chair and Director of the Jean Monnet Centre of Excellence at the Complutense University of Madrid; President of the Jean Monnet Foundation

Dear Professors: my role as session Chair is, of course, to act as a moderator, but also to frame the main questions that could or should be treated during the session. I intend to do it shortly and in my mother tongue.

1. The first question I have to formulate is whether, given the developments in the past few weeks, we should put aside the ambiguous term 'governance of the euro' and speak clearly and openly of 'economic government of the euro area' without euphemisms.
2. In other words, and said with the same clarity, I am asking you: in your opinion, should the economic policy in the euro-zone be 'managed by common democratic institutions to which the necessary sovereignty has been delegated', to quote Jean Monnet, or would an inter-governmental coordination be sufficient?
3. In both cases, what role should the current European institutions play, if they had to play any?
4. This question is essential: in your opinion, how does the democratic control of the decisions have to be guaranteed?
5. Regarding the modus operandi of possible reforms, I understand that the most feasible system and least subject to obstructions and delays would be to establish enhanced cooperation between countries willing to do so, at least before tackling a more radical reform of the treaties. Do you share this idea with me or, on the contrary, you would prefer other methods?

Strengthening the governance of the euro area: political and **institutional** aspects

Today's discussion concerns strengthening the governance of the euro, especially after the recent changes in the management of the common currency through economic governance and the political and institutional aspects thereof.

The discussion is taking place, however, at a time when the eurozone debt crisis is greater than ever. The debt crisis, i.e. the 'follow-up' to the crisis in 2007–08, is taking on new features and dimensions.

We can no longer speak of a crisis of 'unreliable countries'; we can no longer consider just the outskirts of the eurozone to be in crisis, while the core is on track to healthy growth and so on.

The debt crisis is also affecting the likes of Germany, as we have recently seen from its failed attempt to borrow from the markets. Italy, Spain and France are borrowing at high — borderline prohibitive — interest rates.

In addition, the crisis concerns all eurozone countries and the structure and architecture of the euro as a common currency.

The other dimension of the crisis is Europe's heavily indebted banks. One only has to see how much the ECB has lent European private banks on the interbank market to understand that the banking system is being maintained by the liquidity injections of firstly Mr Trichet and now Mr Draghi.



Nikolaos Chountis

Member of the European Parliament and its Committee on Economic and Monetary Affairs

The crisis, while having a decidedly economic complexion, is in fact political in nature and is rooted in the coexistence of neo-liberalism and democracy, i.e. in the market's policy dichotomy.

The neo-liberal model for economic and political management of the world economy was formed in the explosive decades of the 1970s and 1980s, and its dominance marked the total imposition of this economic way of thinking, 'market efficiency' and 'the free movement of capital' having primacy over social achievements, welfare and job security.

At the same time, all thoughts of democratic control and legitimisation of not just economic choices but also economic policy were brushed aside.

We therefore find ourselves in a paradox — which Greece and Italy are currently experiencing to the full — where governments and parties are successively voted in and social unrest is high but policy freedom in general is limited by the notion that neo-liberalism is the only way forward for the economy.

Thus, both during the 2008 mortgage loan crisis and subsequently in the eurozone debt crisis, politicians, politics and citizens are at the margins, while the markets take centre stage, determining developments and, ultimately, imposing their own interests.

The sovereignty of the markets over politics has therefore greatly influenced explanations for the current crisis and for the policies followed to overcome it.

More specifically, the ruling European elites interpret this global capitalism crisis as a problem of regulation, a problem of erroneous calculations and policies by a national elite which has ruled the global system (economic, political and social) these last decades.

They interpret the crisis not as the logical outcome of a system which creates huge disparities within its societies, limits democracy and overthrows national and popular sovereignty, but as a problem of 'policy technique', i.e. a problem to be solved by the right mix of political, economic and institutional reforms.

For all this, they were not able to anticipate the mutation from the credit crisis which hit the USA and the United Kingdom to the debt crisis now affecting the eurozone.

On the other hand, the policies in place to overcome the crisis are a mix of traditional economic thinking, with the emphasis on austerity, privatisation, circumventing labour rights and disciplining the 'unruly countries'; the characteristic features of this are a democratic deficit and a loss of national sovereignty.

These policies have already had a major impact on Europe's societies and economies, with governments ousted for the measures they have taken or being forced to take other measures which have no democratic legitimacy.

The decision of 26 October 2011 failed even before it was implemented. We have already seen two eurozone governments stand down, dramatic falls in the markets, spectacular rises in lending rates in both 'indebted' and 'prudent' countries (Greece, Portugal, Spain, Ireland, Italy, France, Germany) and officials calling into question whether the '50 % haircut' will yield results.

As regards economic governance and yesterday's proposals from the European Commission, it is now clear that 'strengthening governance of the euro' has become something of a standing joke.

The Commission has been trying for a year to get its package of six initiatives through the Parliament and to get Ms Merkel and Mr Sarkozy to come and impose the Euro Pact on us, following the decision of 21 July. And now, following the decision of 26 October, the Commission is now saying it intends to issue new regulations to: (1) abolish national sovereignty; (2) establish austerity and neo-liberalism; (3) force these policies to be implemented.

The review of the EU Treaty to legitimise the permanent support mechanism under Article 136 and the simplified procedure laid down in Article 48.

The involvement of the IMF in the internal affairs of the eurozone without prior activation of Article 218 of the Treaty on the Functioning

of the European Union (which stipulates that Parliament's approval is required for 'agreements with important budgetary implications for the Union') shows that the EU has taken the path of strongly challenging democratic standards and national sovereignty, to the extent that politicians are now being asked for written assurances regarding the policies they intend to implement in the coming years.

The EU is undergoing radical political change and has passed beyond a critical turning point; the upshot is that the decisions, policy considerations, even the electoral processes of the leading Member State, Germany, now determine the road ahead and the prospects of Europe and the other Member States. They will determine whether or not unemployed people in Greece will get unemployment benefit, whether or not homeless people in Spain will have minimum welfare, and so on.

Therefore, the EU's answer to the global crisis and debt crisis is a poorly defined reinvigoration of political union, a poorly defined kind of 'European integration', which is taking it back almost a decade to the discussions on the European constitution and the substance of European integration.

Here are the questions.

- Is the EU simply a union of countries coordinating an ever increasing number of specific policy features?
- If so, how are people and societies involved?
- How can such choices be legitimised or rejected?
- Is the EU a union of countries and peoples, and to what extent does this dual process have democratic and social legitimacy?
- To what extent are the peoples and social classes of Europe represented in decision-making?

Sadly, the prevailing political forces give no answers to these important questions. They prefer to continue along a path, we know not how long, no longer of European integration but of neo-liberal integration.

But for the left, EU integration and the EU itself are not a panacea. They are not neutral procedures, but foreign to social and class

conflicts within Member States, foreign to political national and global conflicts, and foreign to the sharing of geopolitical power within Europe.

For this reason, one factor that is of crucial importance but is quite often overlooked by the leaders and officials of the EU is the people — the people who since last summer have been reappearing everywhere in the developed world. From the Arab Spring, which removed reactionary and authoritarian regimes in place for decades, to the outraged citizens of Madrid, Athens and Rome, Wall Street, San Francisco, Auckland, Wisconsin, the US and the 99 % movement in London, Frankfurt, Berlin, and Brussels.

For this is the main solution to the crisis, though we must be ever mindful of the democracy, freedom, equality, solidarity, values and visions which characterise Europe as a continent, which gave vision and hope to whole peoples and which for decades spelled hope for the EU, in spite of the initial mistakes that were made when setting it up.

Strengthening the governance of the euro area: political and **institutional** aspects



Amy Verdun

Jean Monnet Chair, Director of the Jean Monnet Centre of Excellence and Chair of the Political Science Department at the University of Victoria

Ladies and gentlemen, it is my pleasure to be asked to speak to you here this afternoon. When I was asked to speak I was first going to be later on tomorrow. When I discovered I was going to be the third section in the afternoon, and probably with the letter V usually the last speaker, I thought I'd give you a bit more light entertainment besides sort of the dull, negative, predominantly critical and sceptical comments that you have heard to date. Not that my talk does not have some of that, but I thought I would give you some lighter stuff.

I was asked to give an academic perspective on the question of how to strengthen the governance of the euro area — both looking at political and institutional aspects. Some of you may know most of what I have to say but I am going to rehearse it anyway. I think when we looked at the issues this morning we had

some of the possible solutions being front-loaded, some of the political economic analysis in the second part, and it is my understanding that this part is sort of a political institutional analysis of where we stand. I will try to shed some light on it from an academic perspective.

It seems to me that the European Union stands at a crossroads and I would like to highlight some of the recent challenges. Obviously the economic challenges that we have been looking at are some of

the bailouts that were necessary because of the countries not being able to refinance their debt. Yet it seems to me that the political challenges are maybe even more serious (not that the economic challenges are not serious). Rather, it is my concern that some of the political challenges are maybe more difficult to address, as it will be hard for us to refocus the orientation of citizens and political leaders in a direction of creating these many solutions that were being offered to us earlier today. We have had resignations of prime ministers in Greece and Italy just this last month, and a change of government in Spain and other countries where governments have been moving from one side of the political spectrum to another. Of course, we also have continuous turmoil in financial markets and the accompanying governance challenges. So the way I have structured the remaining of my 8 minutes are first to look at some of the historical background to the situation, then examine some of the triggers, the EU responses, some of the lessons from some academic literature on European Integration and finally look at some steps for the future.

If we look at the historical background I am often surprised at how many people still need to say we did not see this coming; we did not know what was going on. As far as I am concerned the literature in both political science and economics has highlighted very clearly that the design of economic and monetary union from its very first day was asymmetrical. Earlier in the day we heard about the Werner plan. Already in the 1970s it was clear that the plans to create economic and monetary union were called economic **and** monetary union because we needed something on the economic side and something on the monetary side. Our journalists and students in our classes often write **European** monetary union as the full term for EMU because they have no clue what the 'economic' is all about. And they sure know it is all about 'Europe'. But the term included the 'economic' because it was very much a structure within which something needed to be integrated in the economic domain. It is at this point in time that we are looking at what that 'something' might be.

Hence, we are looking at incomplete economic integration. What has been done in the past is to say that we understand what monetary integration is: we created a central bank, fixed the exchange

rates, even though I could now with hindsight say we understood only that part of the monetary integration process which had been done successfully under the European Monetary System (EMS). But banking supervision, understanding about reporting on national accounting and statistics, and at what level we need to oversee accounting and supervision was not something that was carefully thought through.

On the economic side it was decided that there was insufficient understanding of what it was that one would want to do at the EU level. Because of a lack of understanding it was decided to just leave it for now and work with a system of rules. In a more fiscal federalist system, about which we heard Bob Mundell talk this morning, we could easily create a more federal-like institution with a ministry of finance or a transfer of funds to a higher level that in turn would redistribute. For all of that you would need to decide if you wanted to have more redistribution through a more federalist-type system. Because that was not on the cards when economic and monetary union was created, that part was underdeveloped. But again it was not as if we did not know. In the literature — and I contributed to this literature already back in 1996 and 2000 — we see emphasis on this point by highlighting that once there is a crisis, there will be a recognised need to redesign. And I think we are now in that situation where there is a recognised need, and the question is will one redesign or will one, if you like, give up something.

The rules so far have included the Stability and Growth Pact (SGP), and now we have some presentations about how that has been strengthened. In 10 years of EMU we have seen that just being together in a single currency area means that some matters just go through the market place, we have had presenters talk about the spreads, but also the lack of spreads in earlier stages. I think that one of the other contexts we need to keep in mind is the very severe difficulties with treaty changes, referendums that were necessary for constitutional change but also something that was present already back in the days of the ratification of the Maastricht treaty: increasing euro scepticism. This is a background that makes it very difficult for the leaders right now to say: 'OK this is the crisis we have all seen coming at some point — we know that EMU

needs to be redesigned'. But in the context of increasing negativity around Europe, but also the way in which leaders continue to play, if you like, a two-level game where they say one thing to domestic audiences and an entirely different message in the European context and then subsequently national leaders proceed to blame Europe or each other. It is very difficult to be a visionary leader.

So I just thought I would pull out for you today one of these Eurobarometer statistics about whether citizens think that Europe is a 'good or a bad thing'. These Eurobarometer statistics are from February 2010 and I also looked at the August 2011 statistics. They have not really changed very much. We still see predominantly most Member States thinking the European Union is a good thing and very few countries that are below. It is of course now changing a little, the most recent statistics have not been uploaded yet but it is showing that there is a bit more worry about it. But overall we are still looking at an audience that as a whole thinks the EU is a good thing. And it is something we need to keep in mind as we move forward.

What are some of the recent triggers? The financial crisis, economic crisis, sovereign debt crisis and the euro area crisis. I will speak about those now in turn.

The financial crisis: what I think was remarkable from a citizen's perspective and also from a political perspective was that there was a very slow EU response. Again if we go back to those Eurobarometer statistics, you see that the citizens want the EU to respond. Indeed, they actually find the EU responded fairly well. But if you actually look at what happened in 2008, most of what the EU was doing ended up culminating into a fairly slow response. It is not so surprising because the EU, particularly in 2008 (as a result of the fairly minor reforms in this area in the years prior to the financial crisis) has had very few instruments to respond to a crisis of this nature. Instead what we had was a response from Member States. It was just referenced in one of the earlier presentations: Ireland and securing the bank deposits and being reprimanded by the Germans who then very quickly did exactly the same. In other words, we saw a competition among Member States to respond while the EU had a harder time to act collectively. The EU needed to come up

with a coordinated response; it took some time to formulate what that response might be, then to speak on behalf of the Member States, and again they had to go back to the Member States to have that be endorsed.

Economic crisis, the reduction in growth, the reduction in gross domestic product (GDP) per capita in the period following the onset of the financial crisis, was also quite stark and again the responses to this period were predominantly national. One of the reasons we have the debt, and we saw again in the presentations earlier the reasons why we have increasing debt in the European Union, was the belief at that point that they were all thinking like Ben Bernanke (Chairman of the US Federal Reserve): 'The last thing we need is that nobody does anything. By all means spend your money!' At this point, of course, everybody was thinking: 'Well there must have been a balance between spending money and not spending everything', but anyway it was a national response to the economic crisis.

Now we are into the sovereign debt crisis, which clearly follows the heavy spending that has happened, with Germany initially opposed to any bailouts, but then in the end a bailout was necessary. It was a very difficult period of the EU trying to find the right tone and the right tools. Yet the EU did find a way to create the European Financial Stability Facility (EFSF) and plan for the establishment of the European Stability Mechanism (ESM). And they were looking to create new instruments that consist in my view of being quite big steps forward compared to where the EU was in the early days. Now in the past days and weeks we have seen proposals for deeper political and budgetary integration and talks about fiscal union. Again, I think these are huge steps compared to where the EU was even just a year ago.

Today we are looking at the euro crisis turmoil and political crises, including fall of national governments, which I have already mentioned briefly, and I think these are really serious challenges for the European Union. Also in part because it is hard for the citizens to keep an understanding of who is in charge and what could be some of the solutions, the EU is faced with a major challenge.

Let us turn to some of the more academic work in this area, to learn some lessons from the European Union's history. When the

crisis first erupted it occurred to me that we are seeing yet another crisis. If we put this crisis in the context of a whole row of crises that we have seen, it almost looks like the European Union is more frequently in crisis than it is out of crisis. Think of the long process of UK entry into the European Economic Community, the empty chair crisis of the late 1960s, eurosclerosis of the 1970s and 1980s, difficulties surrounding the Maastricht treaty (in particular the ratification of that treaty), the run up to stage III of EMU, and so on; some people say it is the most amazing thing that happened that EMU even got off. Then there is the Constitution and its aftermath, which includes the French and Dutch referendums that stalled the constitution process, then the reflection period that led to moving from the Constitutional Treaty to the Lisbon Treaty. It is not an exaggeration to say that the EU has experienced quite a lot of crises. Having said all of that, I do think today's crisis is of a different order of magnitude. It is something that is not just in the internal heart of the EU but it is on every newspaper in every continent and everybody seems to have an opinion of it, including US President Barack Obama coming up in the G20 saying something like this (and I paraphrase): 'You guys have a lot of different democracies and hold a lot of meetings. But at some point you need to get stuff going'. I think it is something that says a lot.

Another lesson of European integration is again to remind ourselves that the European integration process followed a sequential set of steps but these would not have necessarily needed to be exactly in this sequence. Yet, we are looking at a very late stage of integration and that in each of those steps the progress has been made in order to proceed into deeper integration. We are now somewhere between economic and monetary union and political union, and if this model does not work we may be returning to having just a single market. All of this states that it clearly is something that the EU has not really thought through if it is as easy to go back as it is to gradually move forward. Now in the literature of European integration we have a lot of theoretical approaches about how to understand integration and how integration problems are being solved. I have just put down four different approaches here that I draw on an earlier book I did (Heipertz and Verdun, 2010) published by Cambridge University Press, in which we looked at the Stability and Growth Pact.

What I think is most remarkable is that the literature on European integration never really settles on the answer to the question as to what drives integration. There are the people who argue that it is always the Member States it is has to be in their interest, so an inter-governmentalist approach that focuses on state interests and bargaining between leaders. Then there is a more functional approach, there is a need to do it now, so we need to do the next thing, there is a lot of domestic politics, which is typically a little underestimated in integration theories because they typically focus on what happens at the EU level or how integration has moved forward. But a lot of trends can be traced back to what happens in the domestic arena. Then of course there is the role of experts and technocrats. What we have seen if one looks at these four approaches is that the biggest weakness at the current time is sort of, if you like, the intergovernmental. It makes it very difficult for national leaders to decide if it is in their interest individually to be proactive on Europe and then have to sell that back to their constituency, to do that and seem to be a winner. If we now have had numerous governments changing direction after elections, because you know, the financial crisis has been interpreted as a failure of this government, then just to stick out your neck and try to do something seems to be very difficult. I would hope that they are willing to make that step, because I think that is the leadership we need right now. I could speak to the other three but I think that at some point the chair will look at me from behind and say my time is up. I am happy to speak on these other points.

So drawing to a conclusion, I think we are looking at a challenging economics that shows the limits of EMU's institutional design. It means that the asymmetrical institutional structure of EMU is being brought to the test: how much monetary integration can you have without deeper political and economic integration? We have weak political leadership and with weak political leadership I mean that those actors that have traditionally been taking the lead to move the integration process forward are not as strong today as they may have been in times gone by. So typically we look at the Franco-German axis and it is not something that will surprise any of you that it is not a particularly warm relationship between German Chancellor Angela Merkel and French President Nicolas Sarkozy. But it is also something that I think the rest of the Union has responsibility over, the leadership that would have been possible to be set up by

having a leadership of the European Council, the leaders that were chosen were those that would not rock the boat. You may remember all the discussion we had about whether we could have a Tony Blair or whether we could have a whoever it would be, but it should not be somebody who makes national leaders feel uncomfortable. So, it wasn't only is Merkel doing well or Sarkozy doing well, it is also the rest of the EU not willing to give the power that could be there to strong leadership in the EU context. The experience of the past is that the EU only makes small incremental path-dependent steps towards solutions. That is particularly trying at this period of time and in that sense it is, in my view, very optimistic that we are now seeing lots of people speaking about various different options and solutions and possible steps forward. Because I think these steps are very difficult to make for the European Union. It always requires many different steps and everybody needs checks and balances and needs to think it through and have the experts thought about that and what we need to do next. And that is merely one of the downsides of, if you like, I think a fairly democratic Europe, even if democracy does not mean that everybody feels involved. That definitely is an issue. But having said that, I think the question for the next little while is how do you govern Europe without a full commitment to political union, whereas a state-like equivalent would use state-like tools to respond. And also, one of the concerns is those citizens who were still permissive towards the European Union. Will they be sympathetic to an EU that has taken such a long time to solve the problems? And I think if we look at the situation in Spain and Greece and Italy with very high youth unemployment we are running the risk of a lost generation where so many people are unable to find work. It's a bit sad to think that with a restructuring comes responsibility for a nation state to solve its financial problems, but that then gets downgraded on those that are very weak in society. Maybe the very brilliant will go and move from Spain or Greece or Italy to countries in the north but those who are looking after elderly relatives or have young children at home or don't feel secure to go to another country where they might not get welfare state payments right away, they will not go. And they will be sitting in an environment where it is very difficult to find a job. I think it is the responsibility of the EU to think of those people as citizens of the EU and not just subjects of the nation state that has failed to do its finances. We need to think about how good our proposals are and what are we going to achieve. I think I will leave it there.

A strengthened government for the eurozone: political and **legal** considerations



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Introduction

The next few years will determine if European integration falters and loses normativity or, to the contrary, the process is revitalised and new qualitative strides are made. One thing is certain: things are not going to stay the way they are. Conditions do not exist for a consolidation and a slowing down of the project, as was believed after the enlargement of 2004 and the failure of the European Constitution. The current mix of political and economic crises surrounding the single currency demands a strengthening of integration both inward and outward if we are not to see the process slip backward.

It is no secret to anyone that the European Union has seen better days. On the geopolitical stage on which the United States

and China are competing, Europe is not a global player. For the past 4 years, the economic crisis plaguing our continent has also led to a certain degree of retreat toward the individual state. But this trend, in which policy seeks refuge in the national realm, had already begun some time ago in the EU. Integration had already lost normativity, appeal and the ability to mobilise, even before the euro crisis struck.

To some extent the European project has been a victim of its own success. Some time ago it achieved its fundamental goals of peace and shared prosperity, with fantastic landmarks such as the

creation of an internal market, a single currency and the enlargement from six founding members to the current 27, representing nearly 500 million people. The current refusal to take full advantage of the European system in order to fight the worst economic crisis in 70 years stems from this lack of European impetus. The crisis emerged just when we were still going through some particularly tough years, marked by the failure of the Constitution and adaptation to a more complex Europe composed of 27 very different Member States. But the crisis has highlighted how, now more than ever, what is needed is a European political power with the legitimacy to manage the EU economy and make its decisions stick.

The complications besetting the current 27-member Union are due not only to its size and the scant pro-European sentiment of some of the new Member States. Rather, the problem is that among the governments of the most populous countries a kind of distancing from the integration process has taken root. The French and German trend toward less Europeanism has greatly weakened the historic duo that drove and energised integration. Today, relations between Paris and Berlin are not what they used to be. They have gone from being the axis that shaped all major proposals for moving forward in economic and political integration, to becoming a relationship that is complicated and, at times, a bit forced. It is no longer a pact among equals who identify long-term interests and seek ideas that are attractive for everyone. Between these two countries there is now just a weak agreement to help each other out over the short term. They have failed to generate an appealing vision of Europe with robust supranational institutions, a vision the other countries could sign up to. Both governments should resist the populist temptation to blame 'Brussels' for the world's woes and, with a view to the long term, manage their concerted actions. This is the only way to confront the crisis with the advantages that come with a bloc on the scale of Europe.

Three challenges in relaunching economic and political integration

Mired as we are in a moment of European disorientation, it is easy to neglect the fact that integration involves steps forward but also crises and setbacks. A kind of will-driven or Hegelian vision of history

dominates many allegedly pro-European arguments, according to which the EU is running on autopilot toward a supposedly inexorable destiny. However, first the Community, and then the Union, have been forced to face all kinds of unforeseen circumstances and difficult situations. The way to stay the course toward integration has been to combine the ability to adapt the project to the needs of each moment and political leadership committed to dynamic European ideals — in other words, the opposite of blind belief in progress.

However, in the euro crisis the Union faces three legal and political challenges — not at all simple, and interconnected. I dare say that in resolving these challenges the very future of the EU is at stake. In essence, the three challenges illustrate the high degree of economic and political integration the EU already enjoys, and they can be summed up thusly: what is Europe's political and legal model and how can it be strengthened, to what extent should the EU's drive to achieve results take precedence over reforming the rules of play and over constitutional introspection, and how does one limit the powers of the EU while at the same time allowing it to undertake new tasks?

These challenges appear constantly in debate on the idea of economic government, and will engage us thoroughly for the rest of this decade.

1. Rescue the legal–political model after the constitutional rescue

Despite the elimination of the term European Community with the new Treaty of Lisbon, and people's sense of being fed up with endless debate on treaty reform, with the new Treaty of Lisbon it is necessary to enhance the EU model implicit in the rules of play of the old and the new European Union.

This political and legal system has been created gradually, over the course of more than 50 years, on the basis of institutional practice, the jurisprudence of the Luxembourg tribunal and how it is received by national judges, and successive treaty reforms.

The EU model is based on the simultaneous creation of a legal federation and a political confederation, in such a way that the Union

limits economic protectionism and nationalist excesses (and also regional ones) in its Member States, but never aspires to replace them and therefore shies away from a statist European discourse, which is artificial and counterproductive.

In order to preserve this model, the role of European Union law is essential. From a legal standpoint, the goal of simplifying and strengthening the European community of law has not been achieved following the failure of the European Constitution, an event which also weakened the so-called 'material constitution' (basically, the rules governing relations between the EU and its Member States and between the EU and Europe's citizens). The rescue of the Constitution's contents via the Treaty of Lisbon has produced a text that is very complex and does not sufficiently strengthen the European judicial system and EU legal structures, which are essential for developing the internal market and common policies.

From a political standpoint, we have reached a point of confusion, in which people often make the mistake of seeing integration as a clash, or a zero sum game between the European project and the development of Member States' identity. This forgets that the Treaty of Rome of 1957 was enacted to provide peace and shared prosperity to Member States through a common market, not to try over time to erase them and put in their place a European macro-state.

It is true that integration requires states to subject themselves to legal and economic discipline, an exercise which benefits them over the medium and long term. However, in the language of politicians and communicators there often appears in a very blunt way the idea of 'Europe vs. its Member States'. And the clash of interests between the two levels of government is dramatised in an exaggerated fashion. But people do not realise that European integration does and must mean national integration, and therefore the revitalisation of the identity of each state.

So it is wrong to apply the models of political organisation of a state to the European institutional system, be it in order to understand it or to criticise and reform it. Many things can be exported

from the national to the European level in terms of the technology of democracy: greater transparency, better accountability, limits on power. But the European Union has its own system of separation of powers, and checks and balances, which is just as good as the national one. And European democracy is not comparable to that which exists at the national level. It must be founded on pluralism and diversity of identities, on a cosmopolitan vision in which the national projects of Member States are respected and renewed even as European integration moves forward.

2. The EU should aim to achieve results, but must also continue to debate in a democratic way on the European decision-making process and on its identity and constitutional values

During the constitutional ratification process, much political energy was invested — too much, in fact — and the end result is the very pragmatic Treaty of Lisbon. It was and is necessary to break out of the constitutional labyrinth. A results-oriented approach seems most necessary, given the urgency of the economic crisis and growing demands for the EU to be a global player. But it is also needed as a way to breathe new life into the integration process and in order to be able to present Member States and Europe's citizens with a blueprint for a better EU.

Since last spring we have been locked in a critical and urgent debate: what new economic powers should be transferred to Brussels in order to tackle an economic crisis that is jeopardising the future of the single European currency?

Member governments have resisted completing the economic government of the euro since it was launched in 1999. The clearest example of this inertia was the failure to implement the Lisbon agenda approved in 2000, an ambitious programme of economic reforms that should have borne fruit in 2010 and in the end was reformulated and extended until 2020.

Just 11 years after it was introduced, the euro has not been incorporated into a coherent system of European economic governance. The crisis struck a bloc that had left too many pieces of the puzzle unresolved. Many decisions at the EU level clash with national

decisions, or run into failure to act at this level. Monetary policy is European. But fiscal policy only halfway so, and structural reforms depend on each government. International representation of the euro is fragmented and so far, oversight of the financial system has been in national hands. So the dozen or so banks of true European scale and their clients have suffered from the contradictions and externalities of being part of a single market but also having to answer to regulators with very different requirements and powers.

So after the failure of national-level agencies and bodies to regulate financial entities adequately, recently the EU has finally been moving toward common regulation and supervision through new kinds of EU authority in banking, insurance and securities. At the same time, the Union has decided to create a European Systemic Risk Board to detect asset bubbles and avert financial collapses. And the weekend of 9 and 10 May 2010 will go down in history because of the decision by Member States to create an emergency bailout fund to save the euro from the sovereign debt crisis engulfing some countries, contradicting the spirit of the no-rescue clause of the Maastricht Treaty.

Much more needs to be done. Europe needs to contribute with a single voice to the tough and necessary task of reinventing the rules of play of the global financial system. The presence of half a dozen European representatives in the G20 is not an exercise in harmonic European polyphony but rather a display of cacophony. Over the medium term, it makes sense to thoroughly Europeanise areas such as energy policy, research and development, or higher education. All of them are crucial to the continent's economic future.

But the genie of the constitutional debate has already been let out of the bottle. Put another way, the questions about how we govern ourselves from Brussels still need answers, and it is not possible to go back to the elitism of the first 30 years of integration. For this reason, a results-oriented approach should not neglect the deep, underlying debate on democracy and the legitimacy of the EU. That is the challenge. A technocratic Europe that concerns itself only with getting things done would lack sufficient legitimacy at this stage of the integration process. We must address how we achieve such results and the principles which guide the quest for them and serve

to determine priorities. In other words, we must enhance a kind of EU legitimacy based also on its decision-making processes and its identity. Although the failure of the European Constitution and the difficulties encountered in ratifying the Lisbon Treaty would seem to point us in the other direction, it is necessary to keep improving Europe's rules of play, with gradual reforms of treaties and the Union's institutional law. German Chancellor Angela Merkel may not be after this when she asks to revisit the Lisbon accord, but the effects of a renegotiation would yield their share of healthy side effects for European democracy.

3. The EU must find limits to the continued expansion of its powers even as it undertakes new tasks

All plans to revitalise the European project require the transfer of new powers to Brussels. But as we see in the attitudes of the Germans and the British, these days there is major reluctance to give more competencies and resources to European institutions so they can undertake new tasks, although this is clearly more so the case among their national and regional leaders than among their everyday citizens. In the past few years there has been a loss of confidence in the EU, and the feeling has emerged that it has lost its impetus. In essence, the original project to move toward increasingly close union has been diluted. 'More Europe' is a slogan that has problems, and it had them even before the Constitution project was associated with the absurd vision of a European superstate prepared to erase Member States' national sovereignty.

For this reason it is necessary to consolidate and uphold the current model of economic and political integration, which respects and renews national identities and subjects them to a healthy dose of legal and economic discipline. The only possibility for moving integration forward cannot be continued expansion of European jurisdiction, because part of Europe's legitimacy rests on material limitation of the Union's powers and people's perception that more integration is not tantamount to less national identity.

In that sense, it is essential to take seriously the idea of limiting EU powers and construe that feature not as an obstacle that must be overcome, but rather as part of the social contract that is at

the core of the process and an issue that is key to European and national legitimacy — a pact that could follow the principle I have formulated with the expression ‘limited Union, limited Member States’. The European Union rests on what Miguel Poiarés Maduro called ‘a constitutional order without constitutional foundations’, as a result of which it must limit its material realm of action, even if the system retains enough flexibility for the EU to intervene on a case-by-case basis in new areas. This aspiration to limitation and flexibility requires that eventually some areas of jurisdiction must be open to renationalisation. Meanwhile, through voluntary subordination, the Member States are subject to the permanent limitation of European integration, also in the material realm of their areas of jurisdiction. The distribution and exercising of powers between the European and national level has been the most important legal and political debate since 1992, and for a long time to come it will remain at the heart of European politics. The Treaty of Lisbon has established strict legal limits on current European areas of jurisdiction. Luckily it does not contain a restrictive and rigid catalogue. At the outset of the European Convention, I witnessed the imperious demand in which German regions wanted to transfer their federal model to the new European accord, with an attitude toward Brussels that was clearly defensive. Well, the new classification of competencies is flexible, and it will be subject to a double interpretation: that of the Luxembourg court, i.e. that of the European political process, on one hand, and that of national high courts and national parliaments, thanks to the new subsidiarity protocol.

Both levels — national and European — must exercise responsibly the task of setting out limits to the scope of flexible European jurisdiction.

In any case, the future transfer of new powers to Brussels should be able to happen with the same flexibility with which some can be renationalised. What is more, two risks should be averted: on one hand, pro-European rhetoric, an escapist way of blaming the EU for any pressing problems, often without giving it resources or power to deal with them. The other risk would be that of not being able to make the European realm serve for horizontal learning of solutions that work in different Member States. The sum of the scope of European government and of national areas of jurisdiction can

be a true laboratory for regulation and liberalisation, in the best tradition of federalism.

Conclusions

The real obstacle to confronting these three challenges and overcoming the political and economic crisis is the lack of leadership and strategic vision. It is possible to relaunch the process of integration without the Lisbon Treaty or without reforming it, but not without leaders who are capable of policymaking at European institutions to make them more appealing and thinking over the long term about an attractive political blueprint that nearly 500 million European citizens perceive as something of their own.

Part of the success of European integration has been the gradual, day-to-day development of political and legal community that is growing, moving smoothly with the confidence that comes with the experience of decades of integration.

But at time there have also been flashes of what we could think was the start of a new European epic, an opening to uncharted waters. I am thinking of the surprising Schuman Declaration of 1950, of the ambitious Treaty of Rome in 1957, of the daring step moving to decision-making by majority at the Council of Ministers in the summer of 1987, of the courageous creation of the euro on 2 May 1998 or the successive enlargements that have reaffirmed the ideals of democracy and shared prosperity across the continent. Europe needs more moments like these, ones that are not just decisions on those things we already do from Brussels but rather a reflection of how we want to do things together to share the future. Javier Gomá, a Spanish philosopher, put it this way: 'The European Union has no symbols because the Union itself is the supreme symbol, boasting an extraordinary power to integrate. It is a magic formula, a prestigious brand without a patent and available for use. The originality of this great collective undertaking lies in the fact that we have the symbol before the reality that it symbolises.'

IV.

The EU and global macroeconomic governance (G8, G20, IMF)

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Resolving the eurozone crisis and enhancing global governance



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Introduction

The failure of European governments to resolve the eurozone crisis from the end of 2009 through to the spring of 2012 has major global implications. If not resolved it could result in a serial disintegration of the single currency area and the worst economic crisis since the 1930s. Meanwhile, although the world's leading countries formed a G20 after the financial crisis of 2008, there is as yet no evidence that it will be more effective in avoiding the next financial crisis than was the G20 of finance ministers formed after the Asian financial crisis at the end of the 1990s. Both European and global economic governance are in question.

This chapter posits that there are lessons to be learned in this regard from the manner in which the Roosevelt administration brought

the US out of the Depression of the 1930s, and that Europe can and should adopt them now by enhanced cooperation without the need for either new institutions or treaty changes. It claims that the same enhanced cooperation principle could transform the G20 into a framework for global governance, which can reinforce the effectiveness of UN institutions on a mutual advantage basis. It also draws lessons from the scope and limits of the post-war Bretton Woods conference and the financial institutions that it engendered.

The eurozone crisis

One of the reasons for the failure of Ecofin and the European Council to resolve the eurozone crisis is resistance, not least in Germany,

to debt buyouts, national guarantees, mutual insurance and fiscal transfers between Member States.

Yet none of these are necessary either to convert a share of national bonds on an enhanced cooperation basis to the Union, or for net issues of eurobonds.

1. In funding the New Deal the Roosevelt administration did not buy out the debt of Member States of the American Union, nor require them to guarantee US treasury bonds, nor demand fiscal transfers from them.
2. The US funds its treasury bonds from federal taxes whereas Europe does not have a common fiscal policy. But Member States can finance the share of their national bonds converted to Union bonds without fiscal transfers between them.
3. The EIB has issued its own bonds for 50 years without national guarantees or fiscal transfers, and already is twice as large as the World Bank. The ECB is the guardian of stability, but the EIB Group can safeguard growth.
4. Conversion of a share of national debt to the Union could be on an enhanced cooperation basis whereby some Member States could retain their own bonds.
5. However, a conversion of a share of national into Union bonds could be held by the Union on its own account, rather than traded. This would ring-fence the converted bonds from rating agencies and enable governments to govern rather than the agencies rule.
6. Both Union bonds to stabilise the eurozone and eurobonds to finance recovery could be introduced by an enhanced cooperation procedure which would neither bind those Member States unwilling to adopt it, nor could be opposed by them.

Enhanced cooperation

Enhanced cooperation is a procedure within the European treaties that has rarely been used. But it provides a means by which a minority — or majority — of Member States can adopt a common policy without them all agreeing to or being bound by it. According to the treaties, enhanced cooperation should aim to further the objectives of the Union, protect its interests and reinforce its integration process. Such

cooperation should be open at any time to all Member States. The decision for enhanced cooperation should be adopted: ‘... as a last resort, when it has been established that the objectives of such cooperation cannot be attained within a reasonable period by the Union as a whole, and provided that at least nine Member States participate in it.’

This certainly can be claimed to be the case in relation to the crisis of the eurozone which Member States have failed to resolve for 3 years ⁽¹⁾. Enhanced cooperation has further potential for unblocking the eurozone crisis, in that all members of the Council may participate in deliberations on the proposal of a policy to be adopted by it, but only the members of the Council who want a policy enabled by it shall vote on it ⁽²⁾.

This has major implications for bypassing the current deadlock in the eurozone and also for decision-making through Union institutions. It is entirely different from the procedure for qualified majority voting, or voting weighted by population, which not only favours larger Member States but can in principle bind those in a minority. Nine Member States, or more, are needed to invoke an enhanced cooperation procedure, but more than nine have been unaffected by the downgrading of their debt by rating agencies.

It also has been overlooked that, although an enhanced cooperation procedure was not formally invoked at the time, the introduction of the euro itself was a de facto case of majority enhanced cooperation. It was adopted by some Member States without the euro being imposed on others. The politics also should be self-evident. Nine or more such Member States opting either to convert a share of their national debt to the EU, or to issue bonds for growth and recovery, could not be blocked in doing so by others.

Stabilising the eurozone

The way to stabilise the eurozone is to convert a share of national debt to the Union. The conversion could be either of debt or up to

⁽¹⁾ See further Article 20 (TEU) and Articles 326 to 334 (TFEU).

⁽²⁾ Article 330 TFEU.

60 % of GDP, as outlined in a proposal from the Bruegel Institute ⁽³⁾ or of over 60 % as proposed by the German Council of Economic Advisers ⁽⁴⁾.

1. We and others have supported the former approach for a conversion of national debt of up to 60 % of GDP, but (in contrast with the Bruegel proposal) on the grounds that that this would not require a new institution or the joint and several guarantees to which Germany and other Member States are opposed.
2. The debt converted to Union bonds would not be a write-off or require fiscal transfers between Member States. It would demand that the Member States agreeing to it service their share of it from national revenues.
3. A conversion of debt of up to 60 % of GDP from Member States to the Union would also mean that the remaining national debt of most Member States would be Maastricht compliant. Greece would be a special problem but, as such, manageable.
4. This would not require a revision of the Stability and Growth Pact but could gain it the credibility it currently lacks with markets, where rating agencies such as Standard & Poor's have stressed that resolving the eurozone crisis requires growth.

The European Financial Stability Facility could hold the ring debt. This would be consistent with its stabilisation remit. It could do so even though it is due to be replaced in 2012 by the European Stability Mechanism. The converted debt then could be held by the ESM.

The terms of reference for the ESM have not yet been defined. Those of the EFSF have proved contentious. Yet the principle that converted debt should not be traded would safeguard the EFSF from downgrading by rating agencies and bond markets.

⁽³⁾ Delpa, J. and von Weizsacker, J. 'The blue bond proposal', Bruegel policy brief 2010/03, May 2010.

⁽⁴⁾ GCEE, 9 November 2011 <http://www.sachverstaendigenrat-irtschaft.de/aktuellesjahrgutachten.html>

Issuing eurobonds for recovery

What we are proposing does not differ in principle from the stability bonds proposed by Commission President José Manuel Barroso ⁽⁵⁾. But its context does, in four regards.

First, stabilising eurozone debt does not require the draconian austerity such as has been sought by Chancellor Angela Merkel and President Nicolas Sarkozy in their Stability Treaty or Stability Pact, which will neither work in reducing debt on a sufficient scale, nor gain political consent.

Second, cumulative austerity on the lines that the treaty or pact intends will be profoundly damaging for the US and the emerging economies by reducing European imports from them.

Third, while some national debt needs to be reduced, Europe needs to recover sustainable growth which is the best means of reducing debt and deficits. This was shown by the Clinton administration, in whose second term growth had ensured that the federal budget remained in surplus for 4 years.

Fourth, to finance such growth, the EU should issue its own bonds rather than only national bonds denominated in euros. Such eurobonds would not only attract investment by and from the central banks of the emerging economies and sovereign wealth funds, but also thereby fulfil a key role in recycling global surpluses and thus sustaining a more balanced global economy.

Our case in this regard draws on that which one of us made to Jacques Delors in 1993. It lay behind his recommendation that Europe should issue its own bonds to counterpart the deflationary effects of a stability and growth pact constraining national spending, by ensuring that the Union could finance investments in the cohesion areas of health, education, urban renewal and the

⁽⁵⁾ European Commission, Green Paper on the feasibility of introducing stability bonds, COM(2011) 818, November 2011.

environment, and also finance also a European venture capital fund for small and medium firms ⁽⁶⁾.

This design drew directly on the Roosevelt New Deal which achieved recovery from the Depression not by cutting debt and deficits but by shifting savings — high in either a recession or depression — into socially productive investments which also had a major regional dimension, such as in the case of the Tennessee Valley Authority. Drawing on the precedent of the New Deal, it also recognised that European bonds could finance structural, social and regional policies which had been the intent of the 1956 Spaak report for a common market ⁽⁷⁾.

Both stability and growth

Financial inflows to eurobonds from the central banks of emerging economies and sovereign wealth funds could make the commitment of Member States and the European Parliament (since 2008) to a European economic recovery programme into a reality. This would in turn be to the advantage of both the emerging economies and the US.

The bonds could be issued either by the European Central Bank or by the European Investment Fund which one of us recommended to Delors in 1993. This was set up by him in 1994, and its role was downgraded (after Delors resigned from his 10 year presidency) to investment guarantees for small and medium firms. However, in recent discussion of a proposal for restarting growth from the Economic and Social Committee of the EU ⁽⁸⁾, a representative of the EIF confirmed that it could issue eurobonds without a treaty revision. It is also now part of the EIB group which has massive and successful experience in bond issues since 1958. Since 1997 it

⁽⁶⁾ Stuart Holland, *The European imperative: economic and social cohesion in the 1990s*, Spokesman Books, Nottingham, 1993. Foreword by Jacques Delors.

⁽⁷⁾ Intergovernmental Committee on European Integration, *Report on the general common market* [the Spaak report], Brussels, 1956. MacDougall Report, pp. 14–15.

⁽⁸⁾ European Economic and Social Committee, 'Growth and sovereign debt in the EU: two innovative proposals, ECO 307, February 2012.

has also had a remit to do so in order to finance cohesion and convergence investments in health, education, urban renewal, green technologies and protection of the environment. It has quadrupled its lending and now is more than twice the size of the World Bank.

Although initial flotation of the bonds would be incremental, the cumulative inflows from a share of the surpluses of the central banks of the emerging economies and sovereign wealth funds would be substantial, not least when China alone has surpluses of more than USD 3 trillion. The inflows could well come to match or exceed the Commission's own resources and do so without the fiscal transfers which Germany and some other Member States oppose. Incremental issues of eurobonds could also be oversubscribed which would merit a low interest rate on them ⁽⁹⁾.

Global implications

If some Member States of the eurozone default, and the single currency serially disintegrates, there would be catastrophic consequences not only for Europe but also for the US and the global trading system. Yet debt stabilisation by cuts alone in Europe, without a recovery programme, would be profoundly damaging for the US and risk a double-dip recession in both. By contrast, net issues of eurobonds would:

1. secure the euro as a reserve currency and contribute to the more plural global reserve system which is one of the main aims of Brazil, Russia, India, China and South Africa;
2. contribute to balanced global growth, which is a central aim of the G20, by recycling global surpluses.

The implications for the US of the euro as a global reserve currency are two sided. The dollar would no longer have the advantage of being the sole reserve currency. Inversely, it would not be subject to the risks of not being able to sustain this.

⁽⁹⁾ The interest rate is of less concern for central banks of emerging economies and sovereign wealth funds than to diversify their holdings from dependence on the dollar. The bonds therefore would primarily have a store of value function rather than only revenue generation.

The depreciation of the dollar due to its twin trade and fiscal deficits has been long standing since the Nixon devaluation. But the downgrading of US treasury bonds by Standard & Poor's in April 2011 was the first since S & P started ratings 70 years ago. The rating change from 'stable' to 'negative' means that there is a one-third chance of a further downgrade in the next 2 years.

Unlike the US, Europe is broadly in balance in its trade with the rest of the world and has no fiscal deficit as a Union, nor would it have one on the basis of Union bonds without debt buyouts and without national guarantees or fiscal transfers.

Net gains for the US would depend on net issues of eurobonds to finance the European economic recovery programme. With such a recovery, and with Europe a third of the global economy, US exports would increase. In its own interest, yet also to mutual advantage, China could agree to an orderly reduction of its holdings of dollars, or to maintain them while its net surplus flows are into euros.

Beyond Bretton Woods

During the 2008 financial crisis calls were being made for a 'new Bretton Woods'. Yet we suggest that such a new agenda for global governance also should also recognise the limits to the original Bretton Woods design, and also the intentions of Keynes for the 1943 'Keynes plan'. For this was not realistic at the time, nor can the world now simply go 'back to Keynes'.

1. The Keynes plan was also politically unrealistic. It failed to gain acceptance at Bretton Woods because it was supranational. His International Clearing Union would have imposed penalties on both surplus and deficit countries and have obliged them to revalue or devalue. This was unacceptable to the US then and is unlikely to be acceptable to the major emerging economies now.
2. The Keynes plan was a system designed for already developed economies in a still colonial era. Most of Africa and much of Asia were not 'at the table' at Bretton Woods, just as they still are not in the 'green room' meetings by which some developed countries set the WTO agenda and then are surprised that, since Cancún, this has been challenged by others.

3. While Keynes was right in stressing the role of effective demand, the key issue now is meeting the latent demand for higher levels of income and social inclusion of the 1.4 billion people who are living on the margins of existence on the equivalent of less than USD 2 a day and, because they have next to no income, cannot generate either local effective demand or contribute to the expansion of world trade.
4. This could be achieved by the G20 constituting itself as the governing body of a world development organisation which could address issues of global economic cooperation on the same principle of enhanced cooperation as we are recommending to resolve the eurozone crisis.

Not only the IMF and World Bank

Such a new framework for global governance would imply key roles for the IMF and the World Bank, but depend not only on them nor on a protracted renegotiation of voting rights, for several reasons.

1. The IMF and the World Bank alone cannot assure either global recovery or sustainable world development. They lack the resources.

On his appointment to the IMF, Dominique Strauss-Kahn called on the major world economies to agree a global economic stimulus, and later proposed that the central and eastern European Member States should gain early access to the euro without strict financial conditionality, yet gained no effective response. Robert Zoellick then also called for the European Union to do more to assist central and eastern European economies than the World Bank can offer, but gained only a partial response.

2. The sovereign wealth funds should be part of a new global financial framework.

The sovereign wealth funds of China and the Middle East already have resources more than double those of the IMF. Three of China's four state-owned banks are now the biggest in the world. China has sovereign control of their surpluses and does not gain from ceding it to a single supranational institution such as the IMF.

Where it could gain, as could the sovereign wealth funds of the Middle East and those being created by Brazil from the surpluses of its new oil finds, is from an international organisation which does not claim sovereignty over them, but through which they could mobilise effective joint actions in regional and global investments which can sustain demand in the global economy.

3. Regional development banks and funds have the potential for both regional and interregional global roles.

The borrowing and investments of the European Investment Bank are already more than double those of the World Bank. The Banco Nacional de Desenvolvimento Económico e Social, or BNDES, of Brazil, also bigger than the World Bank, is joining forces with the Comunidade Andrina de Fomento to finance projects in adjacent Latin American countries. Such development banks and funds should be represented in the working groups of a new world development organisation.

4. A major reform of the IMF and the World Bank may be merited but could be highly contentious and not gain the support of the US Congress.

The very modest 2008 IMF quota and vote reform took nearly 2 years to negotiate, yet was cosmetic. China and India between them gained not a fifth of the voting share in the IMF, but a fifth of the share that the US holds in the IMF. If they were to gain a share proportionate to their global influence this could be rejected by the next Congress. By contrast, support by a president of the US for a new global development organisation that does not depend on protracted reform of the IMF and World Bank, nor would be supranational and override the sovereignty of the US, could gain the support of the Congress.

Enhanced cooperation and the G20

As with the proposal that the European Union could resolve the eurozone crisis on the basis of enhanced cooperation, this also could be the principle on which a world development organisation, of which the G20 nominated the governing body, was able to address issues of global cooperation.

This could give agency to like-minded governments in the G20 on joint initiatives and policies, such as an orderly recycling of global surpluses, without binding those who decline to participate in them. The IMF and the World Bank would report to the WDO much as had been recommended by Dominique Strauss-Kahn when he was the director of the IMF. This would enhance both its and their effectiveness without the need for a protracted revision of the voting on their governing bodies.

A world development organisation would parallel the WTO. But it would be based on joint actions to promote sustainable growth and development rather than a rule-governed mechanism for trade such as that of the WTO. It would not exclude future reform of the WTO such as increasing its provisions for social or environmental protection.

It also could relate directly to the UN and its institutions by including them in its working groups and committees, such as those on global finance, employment and the environment. It would thereby be centrally concerned with offsetting global poverty, promoting social inclusion and reducing global warming. Both from them and by also including the main regional and multilateral development banks and funds, it could gain lateral learning of a kind that ad hoc secretariats for G20 meetings cannot.

Traction

Both of the proposals for twin bonds to stabilise eurozone debt and restart growth have gained some initial traction. They have been supported not only by ourselves and by the Economic and Social Committee of the EU, but also by Giuliano Amato, Guy Verhofstadt, Michel Rocard and Mario Soares, former prime ministers of Italy, Belgium, France and Portugal, as well as by Jacek Saryusz-Wolski, former Polish Minister for Europe and by Jan Pronk, former Deputy Secretary-General of Unctad ⁽¹⁰⁾. Both Verhofstadt and Saryusz Wolski (as leaders of the Alliance of Liberal Democrats and the

⁽¹⁰⁾ Giuliano Amato and Guy Verhofstadt, 'A plan to save the euro and curb the speculators', *The Financial Times European Edition*, July 4 2011.

People's Party in the European Parliament respectfully) have been backing them.

The case that the G20 should constitute a WDO, of which it would be the governing body, was also discussed with Permanent Representatives to the UN of China, Japan, India, South Africa, Brazil, Mexico, the UK and Germany at a meeting in New York in 2009, hosted by Nirupam Sen, the High Representative of India. The discussion was of interest for three reasons. Those who came had already seen a paper outlining the case. None of them needed to attend unless they were interested. None of them dissented from it, they rather than asked questions on practicalities.

Notably, the Permanent Representative for Germany commented that it was unlikely that the proposal would be adopted in the near future, but that when 'all else failed' in terms of gaining effectiveness from the new G20, it could be a template on which governments then could draw. Such a time, both in relation to the crisis in the eurozone and the need for a feasible framework for global governance, is not only overdue, but also could be now.

The EU and global macroeconomic **governance** (G8, G20, IMF)



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Shifting patterns in economic power

Some stylised facts

Economic power is shifting from advanced to emerging and developing countries. Emerging markets accounted for nearly two thirds of the total growth in global output in the past 2 years, compared with one third in the 1960s. As a result, at the end of 2010, emerging and developing economies accounted for 48 % of global output (measured in terms of PPP; 34 % when measured at current prices). The EU and US contributed for approximately 10 % and 15 % to world growth respectively in 2010. According to the IMF, the share of emerging and developing countries in global GDP will exceed that of advanced economies from 2013. China has already overtaken Japan

as the world's third largest economy, after the EU and the US.

The global financial crisis has accelerated this shift in economic power — at least for the time being and emerging markets are now the growth engine of the global economy.

The share of the EU and euro area in world GDP declined by about 5 % over the last 2 decades and is expected to decline further over the next 2 years. Nevertheless, in 2010, the EU and euro area still accounted for 20 % and 15 % of world GDP respectively (measured in terms of PPP; 26 % and 19 % when measured at current prices). At the end of 2010, the EU as a whole remained the largest economy in the world.

Shifts in global economic governance

Against this background, if the EU and its Member States want to continue to play a key role in world economic affairs, they have to agree that they need to speak with one voice and to accelerate the move towards unified representation in international institutions.

In the last decade, the large economic and financial size of the euro area and the existence of a single monetary and exchange rate policy have made euro area policy decisions and economic developments increasingly relevant for the world economy.

However, because of the fragmentation of our representation in international financial institutions, Europe does not have the influence and leadership commensurate to its economic weight. Despite the efforts made to coordinate European positions, on too many issues European representatives have different views and are unable to promote the European agenda and priorities. While this is a handicap already in normal times, in the current situation it is a major drawback that weakens significantly the EU international standing.

It has become increasingly clear that, when faced with a global shock for which a collective response is needed, it is both the size and the expression of unified positions by Europe that matters in influencing the policy responses that will be taken in international financial institutions and I. This is why President Barroso in his 'State of the Union' explicitly called for a more unified external representation of the euro area and announced that the Commission would table soon concrete proposals.

The case for a strengthened EU representation at the international level has been reinforced by recent changes in our internal governance. In particular, further to the joint agreement of the European Parliament and the Council on the legislative package to strengthen economic governance in the EU and the euro area (the so-called legislative six-pack), EU legislation on the conduct of economic policies in the euro area has widened and deepened.

These developments lay down the basis for ambitious progress on the external agenda. To deal with more concrete issues, the rest

of my presentation will focus in particular on two topics: the G20 and the IMF.

G20

The current crisis was a watershed in global economic governance. President Sarkozy and President Barroso, in a meeting in 2008 with the US President in Camp David, recognised that the financial crisis required a globally coordinated response and proposed to have meetings of the leaders of the G20. Without elevating the G20 from a ministerial process to a leader-driven one, many of the bold actions and decisions would not have been taken since 2009. Therefore, the G20 has now become the 'prime forum for international economic cooperation'.

The G20 is unique in bringing together the major advanced and emerging economies to coordinate their economic and financial policies. It has proven a very effective forum for engaging our international partners to implement solutions to strengthen global governance. It is also driving bilateral relations, in the sense that the decision taken in the G20 is a reference for leaders when they meet and discuss bilateral economic relations.

Nevertheless, the G20's emergence has also raised questions about its future role and effectiveness. The G20 is still very much in a learning mode and cooperation in the G20 is founded on voluntary cooperation. Such an approach is encountering problems in delivering concrete policy actions, e.g. with regard to resolving global imbalances. The G20 therefore risks losing relevance when the momentum for coordinated policy action fades. The G20 should ensure that its informality does not mean that there is no need to follow through on its political commitments (cf. Cameron report).

Europe is pushing for more macroeconomic policy coordination in the context of the G20 'Framework for growth' initiative, in order to boost growth and reduce global imbalances. Europe is also actively promoting adherence to and implementation of financial regulatory reforms. We are active on topics such as the reform of the international monetary system and commodity price volatility. In addition, the G20 is an appropriate platform to inform our partners

of developments in Europe and how we are addressing the crisis, while we receive feedback from our partners.

On several occasions, the EU has been successful in getting its views across. For example, the G20 agreed to use a two-step approach to select the countries to be scrutinised and to be submitted to an in-depth analysis so as to identify the root causes of persistent imbalances. This two-step approach, which was first suggested by the European Commission at the G20 summit in Seoul, has been strongly inspired by the excessive imbalance procedure that the EU puts in place to address EU internal imbalances.

Nevertheless, the EU has not always been able to push through its position. The EU G20 members occasionally have views which are not congruent. Our *ex ante* internal coordination procedures are often cumbersome. We also haven't fully settled the question whether agreements by the G20 are strictly binding for all EU Member States. A common theme of my presentation is therefore that we need stronger coordination of European positions to push forward the European agenda in the G20. Equally, we need better internal coordination procedures so that all EU members have some ownership of decisions taken by the G20.

Although better cooperation within the EU and euro area is crucial, solving today's euro area crisis is a global challenge. In that respect, the Cannes summit came up with mixed results. First, G20 leaders committed to ensure that the IMF continues to have resources to play its systemic role to the benefit of all of its members and to stand ready, if needed, to ensure additional resources could be mobilised in a timely manner. However, there was no agreement on the amount and way by which resources would be augmented. G20 finance ministers were tasked to further discuss this issue in the coming months. Second, the G20 agreed on an action plan for growth and jobs to address short-term vulnerabilities and strengthen medium-term foundations for growth. The global economy has entered a new and difficult phase and global imbalances are widening again. This requires an increased attention and strengthened international policy cooperation. It is not only the euro area that needs to do its homework. Enhanced commitment and action is required from the main economic actors as well, especially the US and China.

IMF

Let me now turn to the IMF.

The IMF has substantially strengthened its role over the past years. It has taken a lead in shaping the debate on macroeconomic responses to the crisis and by providing financial assistance also to advanced countries, most notably three euro area members.

Europe has always been a staunch supporter of the IMF and our relationship has dramatically intensified over the past years. The troika of IMF, ECB and Commission is now a standard feature. The IMF's Managing Director is a regular guest at the Eurogroup and Ecofin. IMF management discusses with us our policy challenges.

The 2010 quota review significantly realigned quota shares. We will all have to implement it quickly. In addition, EU advanced economies have agreed to transfer two of their seats to emerging markets. If nothing is done, all this will imply a loss of weight and influence by Europe in the IMF. Against this background, I consider that we need a unified euro area representation at the IMF to be more effective and visible. Looking at last year's quota and voice discussion, the EU was clearly cornered by emerging markets and the US, which led to a suboptimal outcome for EU members. Our current set-up with EU members being spread around many constituencies carries high transaction and coordination costs and above all it is inefficient. The crisis has brought to the fore that it is of utmost importance for the euro area to speak with a single voice on programmes, financing arrangements and the crisis resolution policy of the IMF.

At the IMF, we have initiated changes but more needs to be and will be done. The Commission is actively pursuing the objective of a unified external representation of the euro area in the IMF. The commitment by advanced European countries to reduce their representation in the IMF offers in our view the ideal starting point. It cannot be done overnight as we first need to figure out our internal modalities and the IMF has also to make some changes to accommodate a euro area chair. In my view, the best way to do it is to set out a roadmap, which would start at regrouping euro area Member

States into predominantly euro area-led constituencies, and move after a few years to a euro area-only constituency.

I am convinced that a unified European representation would also be very beneficial for the IMF and our partners as we would have substantial constructive power to exert leadership and promote decisions in the European interest. Europe can provide value-added on advancing surveillance as we see a clear need to have a strong legal foundation for the IMF's surveillance and are committed to engage in constructive dialogue with the IMF on its surveillance of Europe. We have a keen interest that the IMF has the necessary tools and adequate resources to fulfil its crisis resolution mandate. With a single voice we would be in a better position to reshape the IMF's lending toolkit and to exert leadership on this issue, as we are also beefing up our own macro-financial surveillance. Finally, let me recall that Europe has always supported the role of the IMF in low-income countries and as the largest development aid donor; we have a keen interest in shaping the IMF's policy towards its low-income countries. Europe would thus become a player as significant as the US and would be in a better position to promote its interests.

Conclusion

The EU is one of the largest and most significant economic players at the global level. As we have witnessed over the past months, for good or bad, our actions or inactions reverberate around the globe. Conversely, our economy is affected by the policy choices made in other advanced and developing economies. We have therefore a strong interest in a well-functioning global economy and in a rules-based global economic governance.

Fundamental changes in the behaviour of all stakeholders are therefore warranted so as to move towards a more cooperative environment. In particular, Europe too needs to do its homework. We urgently need to bring our domestic house in order and strengthen our internal economic governance. To me this is a *condicio sine qua non* so that we can strengthen our external representation.

We Europeans are slowly, maybe too slowly, figuring out that global institutions need to be reformed. It is a painful process for some of

our Member States, as any reform that will lead to a more unified external representation is likely to limit their individual influence. Still this is the way to go.

In the end, we cannot continue to hold on to archaic power structures in international institutions or attempt to exercise the influence of an era that is long past. We risk that with growth and increasing self-confidence emerging markets will disengage from global dialogue if we do not give them a say and the possibility to mould multilateral institutions in ways they also think appropriate. But this does not necessarily imply that we have to relinquish our leadership role. The increasing weight of emerging markets in global governance can be matched by a stronger European voice, if we make sure that we push forward a single credible position.

Indeed, the EU has an important comparative advantage vis-à-vis other G20 partners, since it has practised enhanced cooperation for 5 decades. Therefore it has a know-how that may prove very useful for the G20 in a long term perspective.

This is the main rationale behind the communication of the external representation of the euro area that we are going to present before the end of the year.

Economic crisis and EU **strategic** challenges

It has been widely accepted that the current economic crisis is tightly linked with the fact that EMU combines a centralised monetary policy with decentralised economic policies. Recently the European Union has taken decisive action to create a much stronger economic and fiscal union. Great efforts are needed to put the European economy on the path to sustainable development. Along with the strengthening of the economic pillar of EMU and constructing missing institutions, the EU will have to deal with some other challenges. In this article I will draw attention to the following three: (1) the distortion of automatic stabilisers, (2) the changing social structure, (3) the need to restore the European idea.

EMU and automatic stabilisers of the economy

EMU was created, inter alia, to cope with chaotic movement in exchange rates caused by different rates of inflation. With EMU, monetary policy was passed into the hands of a supranational authority, which alone determines the size of issue and interest rates. And as the ECB's main objective is to maintain price stability, then one would expect that inflation would be equally low in all countries of the euro area. Thus, its monetary factors — issue and interest rate policy — will be withdrawn from the competence of national authorities.

However, non-monetary factors remained, including the most important one — the growth of labour costs. In theory these must match the growth in labour productivity, but in practice wages increase



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faster due to the policy of trade unions and because of the soaring public sector. For the first 11 years of existence of the single currency, consumer prices rose a total of 18 % in Germany, and of just over 20 % in Austria, Finland and France. In Portugal prices rose by 32 %, in Ireland and Spain 37 %, while in Greece 40 %.

Due to differences in the inflation rate, the price competitiveness of Greek products and services in relation to German ones dropped in a period of 11 years by almost 19 %. In earlier times, to maintain its competitiveness, Greece would have had to devalue the drachma by 19 %. However, within a monetary union this is not possible. Since 1998, Greece participated in the exchange rate mechanism 2 (ERM 2) and on the eve of its entry into EMU, the country held the first and the only revaluation of the drachma.

Since the decrease in competitiveness was not offset by depreciation of the national currency, one should expect that imports will expand and exports will be squeezed. Indeed, throughout the 1990s the Greek negative current account balance averaged 2.8 % of GDP. In 2000–05 it was about 6–8 % of GDP, and in 2006–10 it grew to 10–15 % of GDP. When the country switched to the euro, it for the first time got the opportunity to invoice import contracts in national currency. The local importers did not assume foreign exchange rate risk any more. Previously, when they invoiced trade contracts in German marks or French francs, they understood that by the time of delivery drachma may depreciate, and they will have to pay more. After the introduction of the euro, this limiter has gone. In other words, the expectations of depreciation of the drachma acted as an automatic stabiliser of the Greek current account balance, but it ceased to exist after the introduction of the single currency.

According to one of the Maastricht criteria, the consumer price index should be no more than 1.5 percentage points higher than the average of the three best-performing EU Member States. Thus, if in the latter it is 2 % per annum, then the upper limit is 3.5 %. Consequently, for 10 years this differential would cause the loss of competitiveness of the country with higher inflation by 15 %, and for 20 years — 34 %.

The increase in negative balance on the current account meant that economic growth (Greece, Cyprus, Portugal and to some extent

Spain) must increasingly rely on domestic demand. In Greece it has pushed the expansion of the public sector and unjustified increase in wages. In the short term these measures will allow domestic demand to increase and stimulate economic growth. During the period 1999–2008 Greek GDP grew by 3.9 % per annum, which was quite high by the standards of the EU. The German economy grew by 1.6 % per annum, French by 2.0 % and Italian just 1.2 %.

However, the growth in Greece was not based on a solid economic base. Since the early 1990s, the ratio of gross national savings to GDP steadily declined. In 1991 it was 21 %, in 2000 already 16 %, and in 2006 only 9 %. A similar pattern was true for Portugal (Fig. 2). In addition, in Italy and Spain before the crisis the share of savings to GDP was kept, with a few exceptions, within 20–25 % of GDP, and in Ireland it even grew. When Germany and France initiated the reform of the Stability and Growth Pact, they came out of the situation in their economies where low growth rates were coupled with low inflation and a sufficient level of savings. They did not pay much attention to the possible consequences for countries with high inflation and low savings rates.

Before Greece joined the euro area, the depreciation of its national currency hampered imports of equipment and, thus, modernisation of the economy. Once a country introduced the euro, which is a highly recognised international currency, this obstacle was overcome. At the same time the usual automatic stabilisers became less effective.

Previously, the ability of Greece to borrow in international markets was limited. Loans in Greek national currency were not popular due to the low level of its internationalisation and high inflation expectations. In the economic literature, this phenomenon is called the original sin. Loans in foreign currencies assumed the foreign exchange risk: if drachma-depreciated debtors had to pay more. Having switched to the euro, the Greeks were able to borrow at no exchange rate risk, and their appetites increased. Since investors calculated their own risks with regard to the currency, and not to the country, the cost of borrowing decreased substantially. Greece experienced a wider access to external funding on unduly favourable terms. This caused macroeconomic imbalances that were not

discovered until the global economic crisis hit the European economy. This implies that in the coming years the Member States and the EU institutions need to rethink the existing policy mix, especially for the countries with relatively weak economies, and they should be cautious about future enlargement of the euro area.

Changing structure of the European society

Other pan-European problems, the solution of which is impossible without active EU involvement, are excessive consumption against the backdrop of decreasing global competitiveness of European countries, deindustrialisation of the economy and consequent distortions of personal attitudes, and the dangerous shift in European demographic behaviour. All these factors affect, though to varying degrees, the mindsets of social groups, whose dissatisfaction may turn against the EU and its institutions.

The deindustrialisation process wields significant influence in European society. According to data provided by the United Nations Conference on Trade and Development (Unctad), the share of the population employed in the manufacturing sector shrank to 26 % from 42 % between 1970 and 2008. Simultaneously, the share of the workforce employed in the services sector increased to 71 % from 51 %. These figures indicate that the tertiary sector now employs almost three times as many workers than manufacturing. The closure of mines and factories is not only the sign of depressed territories with structural problems and chronic unemployment. It is also a disruption of the structure of human society and change in the system of personal values. Workers' dynasties, within which people with secondary education considered themselves respected members of society, have been disrupted. A highly qualified 60-year-old lathe operator knew that his work helped turbines rotate and trains run. A 60-year-old waiter, bartender, disc jockey and stockbroker are nonsensical. What consoles people in these professions on the eve of retirement? The speculation of multimillions or decalitres of beer sold?

Mass employment in the tertiary sector significantly complicates personal identification and the search for purpose in life. It multiplies the numbers of alienated workers who do not see their

connection to society and view their work only as a means of making money. Deindustrialisation generates prolonged distortions in the labour market. People who would previously have worked in factories now seek to join the white-collar ranks. In addition to clean work and stable earnings, they also want a confirmation of their own importance. From this situation arises a ubiquitous aggrandisement of the administrative and state machinery. According to OECD data, 10–17 % of government spending in EU countries goes towards maintaining the administrative apparatus, which is comparable with education or healthcare expenditures. Interestingly, Greece, a country where state bureaucrats enjoy unimaginable privileges, does not provide such statistics.

In other words, European society is drifting farther from manufacturing and is becoming increasingly bureaucratized. Europeans, despite a growth of material opportunities, find it all the more difficult to answer the questions formulated by Felix Antoine Philibert Dupanloup, the Bishop of Orleans (1802–78): whence have we come? Who are we? Whither do we go? The lofty goal, the attainment of which an individual is prepared to devote his life to, will be imperceptibly lost in the course of paid bills and applied discounts.

Europe's population is aging; the large 1950s generation of 'baby boomers' came close to turning 60 in 2010. The number of people who have reached this milestone increases by more than two million with each passing year, although 3 years ago this figure was a million people. As of 2014, the able-bodied population in Europe will start shrinking in absolute terms. In practically all European countries, national budgets cannot endure the burden of pension payouts. In order to cope, governments have to upwardly revise the retirement age and to change over to flexible patterns of generating pension funds, and proposing workers increase their personal contributions.

Those retiring in 10–15 years' time will not have an opportunity to complete all the required contributions to the funds if they did not do so earlier. In 1970, there were four to five able-bodied men and women per each retiree in Europe, and in 2010 there were slightly more than three. By 2030 this ratio will decrease even more. It will be two to one in some countries, including Germany. And if one takes into account the fact that no more than 65 % of able-bodied

Europeans are employed (housewives and students are the largest non-working groups), then the ratio of pensioners and workers will be two to three. The existing systems of social security expenditures were not designed to handle such a ratio, and they will not withstand it in the future.

The Bank for International Settlements' (BIS) experts say that state debt will grow to 200 % of GDP in Austria, Germany, Italy, the Netherlands and Spain, and 300 % of GDP in France, Greece and Britain by 2030 if the current structure of state revenues and expenditure remains unchanged. At present, state debt in the euro area is approaching 90 % of GDP, which has already created numerous problems. In any case, national governments will have to reduce pensions. One of the gentler methods of resolving the problem is to fan inflation so it would decrease the real debt burden and the cost of pension payouts.

Another consequence of demographic shifts is the problem of the squeezed generation. Those who are 40–50 years old have been caught between obligations to children and to parents. A 50-year-old man today often has 15-year-old children and parents who are 75 years old, because he had children later in life than his parents did. As the human life span increases, the care of elderly parents and provision of high-quality medical treatment for them require considerable physical efforts and money. Additionally, the cost of raising children becomes more expensive, and the duration of support more protracted. With every passing decade young Europeans leave their homes at an increasingly older age. The same holds true for marriage and reproduction. At present, 75 % of young men and 60 % of young women 20–24 years old across the EU live with their parents and do not have permanent partners.

Separation is especially delayed in southern and central Europe. For instance, 70 % of Italian men 25–29 years old and 35 % of 30–34-year-olds live with their parents and without permanent partners. A new word, *bamboccioni*, or 'overgrown children' has been coined to denote the phenomenon. By remaining in their parental homes until their hair turns grey, they do not strive for economic independence, instead seeking to spend their moderate earnings on fine things, hobbies and entertainment.

People in older age groups have always been critical of the EU, and the conditions of the economic crisis strengthened their negative attitudes. According to opinion polls in 2011, 38 % of people older than 40 expressed trust in the EU, while 50 % did not trust it. Of course, Brussels is not guilty of all the troubles. However, as the euro became a symbol of the EU, so the euro area crisis has become a reflection of the crisis of the entire European model. The accumulation of huge state and private debts proves that the concept of *Wohlstand für Alle* (prosperity for all) has contradicted the rules of globalisation, in which countries having cheap labour and no systems of social security enter world markets.

What can European civil society do in this situation? The first option is to mobilise forces to defend the European ideal and united Europe. The second is to retreat, hoping that the elites will somehow solve everything. Consequences of the latter scenario may be the weightiest, not in the sense of a possible departure of one country or another from the euro area or the EU, but primarily in the sense of further strategies for the continuation of European integration and its ability to withstand the challenges of globalisation.

Will the European idea survive?

The EU's biggest problem today is the loss of the European idea and the vagueness of European self-identity. Following the end of World War II it was clear what Europe needed: peace, concord and affluence. Political and ideological confrontation had accelerated centralising movements in each of the two blocs. The western European countries, with difficulty, experienced the loss of global leadership, the loss of colonies and growth of the international role of the US and the Soviet Union, which is why they gravitated towards each other.

In 1985, when Jacques Delors became President of the European Commission and Mikhail Gorbachev took the reins of power in the Soviet Union, the European idea resounded with new strength. An opportunity had emerged to bridge the continental schism and put an end to the Cold War. It excited people's minds and inflamed their hearts. The next two decades were filled with romanticism and hard work. Western Europeans erected new levels of integration and introduced a single monetary unit. The former socialist countries

built institutions of democracy and market economy. The majority of them received full-fledged EU membership from 2004 to 2007, while Slovenia and Estonia even entered the euro area. Almost all the plans were executed, and dreams came true. The economic crisis which erupted soon after exposed, in addition to Greece's budgetary problems, the absence of a super-idea that would cement the Europeans' sense of solidarity and their readiness to withstand dangers together. The Constitutional Treaty necessary for the transition to a political union had failed 3 years before.

Despite the ongoing process of enlargement, EU leaders have been unable to persuasively answer the question of what it means to be a European today. The European values specified in the treaty — freedom, democracy, human rights, the rule of law — are universal for all in the civilised world, and in no way contain specifically 'European' characteristics. The mention of Europe's Christian roots was eliminated from the text of the constitution when it was still at the preparatory stage.

Moreover, the EU is embarrassed to tell its citizens that contemporary Europe is inconceivable without the legacy of the crusades, the struggles between popes and emperors, the Renaissance, the Reformation and religious wars, colonialism, and the Enlightenment. The socialist period in the history of central Europe has fallen under an unspoken ideological ban: all the bad is denounced while the good is kept quiet. Many citizens of EU states sincerely do not understand the necessity of helping Greece and other countries, which have irresponsibly accumulated huge debts, partly through the aid of accounting machinations. The Soviet threat or an admittance ticket to the EU are no longer arguments for them.

Soon one more factor will cease to exist, which has infallibly bolstered European integration, as the fourth generation born after World War II is about to enter political life in Germany. These young Germans, once they become voters, may well consider that their country has expiated its historical guilt to the Europeans, since it has done so much for their unity and prosperity. A broad public discussion of the goals and instruments of integration was conducted in Europe in the 1950s and 1960s, and it was then that the main ideological and scientific constructs, which support the

EU at present, were designed. No such discussions have been held since that time, and attempts to revive them at the sessions of the convention which drafted the text of the Constitutional Treaty ended in failure.

The most important tasks include fundamental change in the forms of governing the EU and the elimination of the democratic deficit; creating a political forum shared by all the countries, where united political forces would work out and discuss a single agenda; and beginning broad discussions of strategic tasks for Europe and the EU in the framework of globalisation. Incidentally, the absence of a forum of this kind heavily restricts the field of action for supporters of a united Europe. For this reason the decisive role in preparing society for change can be played by mass media, social networks and blogs. If the most conscientious Europeans succeed in using the crisis to initiate large-scale reforms of the EU, the Union and the whole of Europe will receive a second lease of life. EU citizens will feel much greater solidarity than they feel today and the European ideal will be imbued with new meaning.

EU and global economic governance: a **Chinese** perspective



Dai Bingran

Jean Monnet Chair and Honorary Director of the Jean Monnet Centre for European Studies at Fudan University; Secretary General of the Chinese Society for EU Studies

When we gather here in Brussels at this year's Global Jean Monnet Conference, I would think we all have the debt crisis very much in our minds, and in our hearts. Somewhere 10 000 km eastward, the Chinese people are feeling likewise concerned, and are having some heated debates on it, not only because we are heavily hit by the financial crisis as well — maybe in a different context — but also because China has had a very high stake in the EU, as one of its most important trade and economic partners.

Here I would like to present to you some of the thoughts that have come upon me out of the recent Chinese academic discussions, and to present to you some of our understandings and concerns about the current crisis. My presentation will be in three parts, namely:

- Chinese perceptions of the current crisis,
- eurozone reforms,
- China's possible roles.

Chinese perceptions of the current crisis

In the final analysis, debt is a lack of liquidity. When a country is in debt, the usual way to relieve it, alongside increasing revenues and reducing costs, is to raise new loans to cover the old debts. It becomes a crisis when the country is no longer able to borrow, either from the markets or from other countries. And that seems to be the case with Greece.

We all know that the current financial crisis started with the failure of the US subprime mortgage market. Then the question is: why should

Europe and the rest of the world suffer because of a failure in the US financial market, and even more seriously than the US itself?

An answer might well lie in the paradox between the international use and the sovereign issue of the US dollar. While people all over the world choosing to use the dollar is not the US's fault, the US administration has misused and abused too much of the dollar advantage over the years by frequently indulging in the deficit budgetary policy. Whenever they ran into debt, they just tried to cover the shortage by issuing treasury bonds and printing the dollar, thus creating in the world an astronomical amount of speculative capital. This capital is, I believe, very much behind the financial crises — this debt crisis included — we have had so often nowadays.

A possible way out might be to have another international currency, which could, in cases, serve as a substitute to the dollar, as a means for business transactions and for foreign reserves. This was what the Chinese people expected when the euro was created: the new currency, backed up by the largest economic entity in the world, would play a balancing role to the dollar. Unfortunately, for reasons we are all well aware of, the expectation is far from being fulfilled; 10 years prove to be insufficient to make the euro into such a currency. It itself has now become the prey of international financial sharks and has plunged into a crisis unseen in its history.

Eurozone reforms

The eurozone is faced with a double task: to bail some of its Member States out of their debt crisis and to mend the euro mechanisms to avoid future crisis.

It is true that Greece (and some other Member States too) has to be responsible for its heavy debts. However, you must know better than me that the current crisis is apparently not just the problem of Greece, but also the problem of the eurozone, and maybe of the entire EU, because on it rests their common fate. In this sense, to save Greece is to save the eurozone, to save the EU, and solidarity is necessary and essential.

With a consensus on this, Greece would not be difficult to save, as the eurozone as a whole does not lack money, and the world rather

has too much money. At this particular moment what matters may be not just the money, but rather the solidarity spirit and political will of the eurozone. If the eurozone is able to show its determination and muscle, the market will follow the signal.

The bailout of the debt crisis should go hand in hand with the medium- or long-term reforms of the euro mechanisms, that is, to prevent the crisis from happening again and again. There have been suggestions for a fiscal union to go hand in hand with EMU, and the talks about a European economic government. It would be, of course, quite ideal if such steps could be taken. But the question is: are the eurozone or the EU Member States prepared to do so, especially at this moment? We have serious doubts. At this juncture, better to be practical rather than ambitious.

To our understanding, reforms in this context should include three elements.

First of all is a greater vigilance over the fiscal statuses and policies of the Member States. This could be fulfilled through reactivating the Stability and Growth Pact and making it more legally binding for enforcement.

Second, the role and functions of the ECB should be strengthened, along the line of making it really like the central bank of the eurozone. The ECB has been performing very well in maintaining price stability, but as the central bank, its functions should not remain as such for much longer. Its monetary policy should be more flexible and more growth friendly; and it should have the function and the means for monetary operations in times of difficulties, such as issuing bonds and raising loans.

Third, there should be a more vigilant monitoring of the financial markets. In this respect, either or both the Commission and the ECB should play a more active role and work closely with the related authorities and institutions both at EU level and at international level, in order to maintain the stability of the financial markets.

More basically, the EU may have to make more effort towards the reform and adjustment of the real economy. The economies of

the EU Member States differentiated greatly during the crisis. It is not accidental that certain countries, such as Germany, which has had stronger real sectors, fare much better than others, both in sustaining the crisis and recovering from it. And the four socio-economic models in the EU — Scandinavian, Rhine, Anglo-Saxon and Mediterranean — performed differently as well. For the economic convergence in the eurozone and in the EU, it might be necessary to push forward structural reform programmes like 'Europe 2020'.

China's possible role

It is a totally wrong concept for China to 'save' Europe: Europe does not need China to save it; China needs to save itself — our problems are as serious, if not more serious. But it does not mean that, on the question of the European debt crisis, China could or should stand impassive. China's economic wellbeing depends very much on its external economic relations, and Europe weighs heavily. From this perspective, to 'save' Europe is to save China as well.

Then, how? I would think the Chinese government is prepared to take part in the rescue actions, like buying eurobonds with its foreign reserves. But it has been somewhat reluctant, and with good reasons. For one, if the EU countries, as partners in the eurozone, hesitate to rescue Greece, how could China be convinced to intervene? For another, the foreign reserves are hard earned, and not to be squandered away; while China could buy some Greek bonds out of goodwill, the bulk should be guaranteed against losses. So, if there are bonds issued or guaranteed by the ECB or the IMF, China would be willing to hold.

China could also do something to support the recovery of the European economy. Even with the shrinking of its exports to Europe, it has been trying to increase its imports from Europe. And China should try to expand and deepen its economic and trade cooperation with Europe, so as to make their markets more open to each other, not only for goods, but also for investment. Between Europe and China, there is still vast scope for development, and the important thing is to tackle this in the spirit of partnership.

To conclude, in this globalised world, Europe and China share their destiny and have to work more closely.

European debt crisis and Asian responses: a **Korean** perspective ⁽¹⁾



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Introduction

The current debt crisis could have serious repercussions for Asian economies, and in particular emerging Asian economies. More specifically, if the current Greek crisis spreads to Italy and Spain, the world will have a second global financial crisis which will have far more devastating effects on Asian and global economies than the 2008 one did. However, the containment and resolution of the crisis is not as straightforward as that of the 2008 global crisis, owing to the conflicting interests of the Member States. Germany, for instance, is strongly opposed to the use of the ECB as lender of last resort, while most southern European Member States hope that the ECB plays a more active role in helping them more easily finance their government debts. In some sense the current European crisis is also a political crisis, as it would quickly fade if the ECB supported the

troubled southern European Member States more substantially.

Insofar as the European debt crisis is expected to persist, emerging economies like Korea can consider three levels of policies. First, at the national level, the Korean government can explore reintroduction of some types of short-term capital controls which do not

⁽¹⁾ The basic idea of this paper was presented in the Global Jean Monnet Conference, of 24 to 25 November 2011, on 'European economic governance in an international context'. This work was supported by the Korea National Research Foundation Grant (KRF-2009-362-A00001).

violate free-market principles. Korea and many other emerging countries are indeed now trying to do just this. And such attempts are not limited to emerging Asian economies; even the EU is considering similar actions, with one example being its attempt to introduce a Tobin tax on financial transactions.

Second, at the regional level, Korea could consider efforts to strengthen east Asian financial cooperation and take collective action to prevent the devastating effects of crises. During the 2008 global financial crisis, for instance, the Korean Central Bank concluded swap arrangements with the Bank of Japan and the People's Bank of China, which can be considered parts of the regional financial safety net. This regional financial cooperation can be extended further to the taking of common actions against the current European crisis. Korea, Japan and China could, for example, make a joint confidence-boosting announcement that they will support the European countries and are willing to invest in the eurobonds issued by the European Financial Stability Facility, or in other important European member nations' bonds. Given that Japan is already one of the largest investors in eurobonds, and that China has already made a commitment to make such investments, it is high time for the three Asian countries to move together to support European countries.

Finally, at the global level, the Korean government has already been emphasising the need for establishment of a global financial safety net. Strengthening of the IMF's financial resources and financial instruments was one outcome of the G20 Seoul summit meeting in 2010, where this was stressed. And in fact, there is no country in the world more aware than Korea of the importance of a global financial safety net, since Korea has been hit by crisis twice — in 1997 and in 2008. Unlike during the 1997 currency crisis, however, Korea was able to escape from the 2008 crisis owing to the Bank of Korea's currency swap arrangement with the US Federal Reserve System, in the amount of USD 30 billion.

The organisation of this paper is as follows: In Section 2, it looks at how the European debt crisis affects the Asian economies. In Section 3, it examines the possible policy actions that Asian emerging economies can take at the national, regional and global levels. Section 4 then concludes.

Repercussions of the European debt crisis on Asian economies

As the European nations struggle to resolve their debt crisis, Asian countries cannot hope to be immune from the crisis fallout.

First, the impacts of the crisis on their economies are very visible, especially through the turbulence seen in their foreign exchange and financial markets. In Korea, for instance, the exchange rate of the Korean won vis-à-vis the US dollar has increased substantially because of foreign, and especially European, investors who have tried to withdraw their capital from Korea. Foreign reserves have also dropped. Each time there has been financial turmoil Korea has been affected, as it is now one of the most open economies in the world with full capital-account liberalisation.

Second, because Asian economies have adopted export-oriented growth strategies, their rates of growth will be hit by the abrupt fall in export demand and growth of the euro area. Although fiscal consolidation could help European economies to recover their growth potentials in the long run, it is in the short run very likely that their deficits and debt reductions will lead to lower growth and lower demand for imports.

Despite these negative shocks, the European debt crisis can have only a limited impact if it is short-lived. However, its resolution seems a protracted and time-consuming process, and will be very difficult for European countries to achieve quickly. The reason for this is that, unlike the case of the 2008 global crisis (which was able to be eased quickly by the active intervention of the US government and the Federal Reserve), support from the European Central Bank in resolving the current European debt crisis can rarely be relied on, as its statute regarding central bank independence prohibits bailouts of European Member States. During the period of transition from the EMS to establishment of the ECB, it seems that European countries underestimated the need for a lender of last resort, and focused too much on the complete removal of exchange-rate variation. This explains why European countries have had to create a separate European Financial Stability Facility with limited funding power. And as long as containment of the crisis

depends on support of the EFSF, and not intervention by the ECB, it will not be easy to restore necessary market confidence. (See for example Moon (2011) for the contrasting experiences of Korea during the 1997 Asian crisis and 2008 global financial crisis.)

Naturally, east Asian countries hope that the firepower of the EFSF will be sufficient to contain the European debt crisis. There are concerns, however, about whether European countries will be able to mobilise sufficient funds to restore market confidence and solve the crisis by themselves. In particular, given that the size of the EFSF should be extended to EUR 1 trillion, European countries seem unlikely to be able to easily mobilise all necessary funds on their own, and may need support from non-European countries. Many emerging and Asian economies are thus discussing ways of containing the European debt crisis, and committing themselves to provision of funds either individually or collectively. To handle the European debt crisis and contain its impacts on their economies, east Asian countries could consider developing three categories of policy — at the national, regional and global levels.

Asian responses

1. National level policies

At the national level, emerging economies must be vigilant about short-term capital flows. To prevent short-term capital flows from disturbing the Korean financial markets, for instance, the Korean government has decided to reintroduce some types of short-term capital controls, while at the same trying as much as possible to avoid any violation of free-market principles. In particular, a bank levy on non-deposit foreign currency liabilities has been introduced, to minimise the risk from short-term cross-border capital flows. Many other countries are trying to do similar things.

Moreover, some emerging economies like China, Brazil and Russia have shown interest in helping the crisis-hit European countries through investment in European government bonds. This is especially due to the requests by some countries (including Spain and Italy) to countries holding large volumes of foreign reserves (such as China) to buy their sovereign bonds. However, China's attempt to

tie such financial aid to trade concessions (the designation of it as a 'market economy') was ill received by many European countries as a 'menacing act of policy leverage' (*Wall Street Journal* (2011)). The purchase of European bonds by one single country can in this regard be neither sufficient to stabilise the threatened European countries nor politically feasible.

2. Regional-level approaches

Some groups of non-European countries could collectively invest funds in the eurobonds or sovereign bonds of European countries. There are two possible groups that might provide such collective support, the first being the China–Japan–Korea (CJK) bloc, and the second including two Asian countries (Korea and Singapore) and two Latin American countries (Brazil and Mexico).

(1) China–Japan–Korea bloc

At the regional level, China, Japan and Korea could consider working to strengthen east Asian financial cooperation. So far east Asian monetary and financial cooperation has been limited to internal issues, and been based on the ASEAN+3 framework as exemplified by the establishment of the Chiang Mai Initiative (CMI). This financial cooperation can, however, be further extended to include the taking of common positions or actions regarding global financial issues. The financial cooperation between China, Japan and Korea could moreover be strengthened, and in this framework the trilateral cooperation secretariat between China, Japan and Korea, established in September 2011, will be an important vehicle for increasing the countries' cooperation related not only to regional issues but also to the global economic recovery. The leaders of the three countries have also reaffirmed their commitment to work together to deepen overall cooperation, at the ASEAN+3 summit meeting in Bali, Indonesia on 19 November 2011.

From this perspective, one important agenda item that will bind Korea, Japan and China together will be common action to help resolve the current European crisis. One such measure could be an announcement of their intent to invest in the eurobonds issued by the EFSF or by other important European member countries,

which would help to boost market confidence. Given that Japan is already one of the largest investors in eurobonds, and that China has already committed itself to such investment, it is high time that these three Asian countries move together to assist Europe. And because these three countries have huge accumulations of official foreign reserves, they also need to invest their reserves abroad. Until now, however, their main overseas investments have been in US treasury bonds (see Table 1), and so they could decide to diversify their overseas reserve investments and hold more European government bonds.

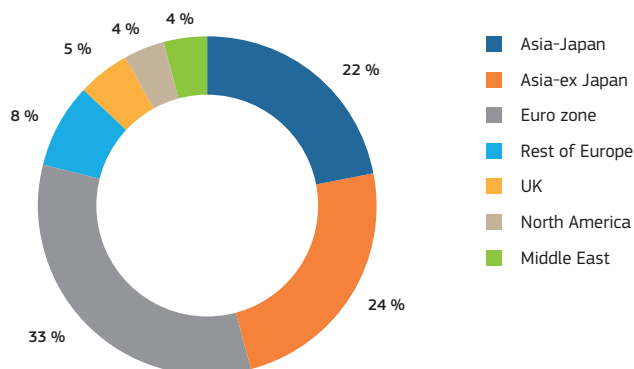
Table 1: Foreign reserves and US treasury bonds held by the CJK (billion USD)

	International reserves (July 2011)	US treasury securities (August 2011)
China	3 245	1 137
Japan	1 168	936
Korea	311	32

Source: IMF

As a matter of fact, Asia as a whole is the most important investor in the European government bond market (see Figure 1).

Figure 1: Geographical breakdown of purchasers of eurobonds issued by the EFSF (EUR 3 billion on 22 June 2011, with 5-year maturities)



Source: EFSF

It is important to note in this regard that, among Asian countries; it is not China with the world's largest volume of foreign reserves but Japan, which is thus the most important Asian investor. There are two reasons for this. First, apart from the official foreign reserves owned by the government sector, private investors in Japan have a huge pool of savings which they are eager to invest abroad, while the private sector in China does not have sufficient savings and still needs more capital from abroad. Further, private investment in countries like China is prevented because of capital controls. Secondly, Japan has an exceptionally low interest rate, so that the current yield on eurobonds (5 %) is already quite attractive enough to induce Japanese investment. Given the current appreciation of the Japanese yen, massive purchases of the euro accompanied by selling of the yen also helps to mitigate appreciation pressures on the yen. To a lesser extent, Korea, with the second largest institutional investment market in Asia, is also eager to invest abroad. This is not the same case for China.

(2) Korea–Singapore network with Brazil and Mexico

Some Asian countries could collaborate with countries of other regions to help increase the firepower of the EFSF. During the 2008 global financial crisis, Korea, together with Brazil, Mexico and Singapore, concluded swap arrangements with the US Federal Reserve in amounts of USD 30 billion each. The total support available from these four countries was thus USD 120 billion. They could theoretically have invested up to USD 120 billion in the European rescue fund. (The problem, however, is that a country like Korea needs to protect itself from eventual capital outflows, which explains why Korea has devoted such great efforts to accumulate as much foreign reserve holdings as possible.)

One important pre-condition, however, is that a swap between the ECB and the central banks of these countries would need to be set up first, if the need were to arise. For Korea, for instance, investment in eurobonds could be facilitated by its strengthened financial position thanks to its two recent swap agreements with Japan and China. In October 2011, in the face of the European debt crisis escalation, Korea and Japan agreed to expand their currency-swap arrangement further to USD 70 billion. Later, in the same month,

Korea and China agreed to double the size of their won–yuan swap arrangement, from the existing USD 26 billion to USD 56 billion. A future possible swap between Korea and the ECB would certainly help Korea to invest more substantially in European government bonds.

No matter what groups of countries are ready to support European countries, however, there is one important barrier to investing in European bonds. The European government bond markets are not yet completely unified; they are fragmented, and thus as a whole can thus never be compared to the US treasury bond markets. Under these circumstances, it is needless to say that European countries should focus their efforts on creating a consolidated eurobond market.

3. Global-level cooperation and the G20

At the global level, the Korean government has been emphasising the need to establish a global financial safety net ever since it began participating in meetings of the G20, which has emerged as the world's premier economic forum since the 2008 global financial crisis. Indeed, the strengthening of the IMF's financial resources and financial instruments are outcomes of the G20 summit meeting hosted by Korea in 2010, in Seoul. And so, if the IMF creates an external rescue fund or a special vehicle to support the EFSF or European Member States, it is very likely that Korea and some other emerging G20 countries will contribute substantial amounts of their huge levels of foreign reserve assets to it (see Table 2).

Many emerging G20 countries, including Russia, Brazil and China, have shown interest in providing financial resources to help stabilise the European debt crisis, but they have all required as a precondition that European countries put their own houses in order first before relying on external funds. However, if the Greek debt crisis is not contained quickly by the European countries themselves, and if larger European countries such as Spain and Italy face economic crises, the IMF and G20 countries will be forced to support these European countries regardless, in order to prevent propagation of their crises to other countries and regions. In this regard, it is important to strengthen the financial support capacity of the IMF,

Table 2: Foreign reserve assets of emerging G20 countries (August 2011)

	Foreign reserves (USD)
Argentina	49
Brazil	354
India	322
Indonesia	124
Mexico	138
Russia	545
Saudi Arabia	445
South Africa	49
Turkey	95
Korea	311
China	3 245
Sum	5 677

NB: The data for Mexico and Saudi Arabia are as of July 2011 and December 2010, respectively.

Source: IMF

as its existing financial resources are quite insufficient for coping with the European debt crisis. In addition to the chances that it will give them to increase their quotas in the IMF, the financial contributions to the IMF of emerging G20 countries will also be of benefit to them since they can still be counted as belonging to their own official foreign reserves. And with these considerations in mind it is expected that the IMF will eventually increase its financial firepower up to USD 1 trillion.

Conclusion

The EU will eventually manage to contain its debt crisis. The history of European construction over the last 50 years shows that there have been many such periods when Europe has been hit by severe economic or political crises. European countries have always overcome these crises, however, through enhanced cooperation and collaboration. This is in fact one important lesson to be drawn from the European integration process, and in this sense Europe can be expected to also overcome the Greek crisis. It will of course take a considerable time for the crisis-hit countries to overcome

the crisis, because the real cause of the current economic problems in southern European countries is the loss of their international competitiveness. They are at the same time unable to rely on what would be an easy solution to this problem, currency devaluation, since they have all adopted the single euro currency. They will instead need to reduce their public and private spending, which will certainly dim the hopes for an early European economic recovery. In this regard, the financial support of Asian and other non-European countries will be crucial in helping Europe to overcome the crisis more easily and quickly.

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VII.

Closing session

Jan Truszczyński

Marco Buti

Fritz Breuss

Etienne Davignon

*Dusan Sidjanski**

*(*apologised for his absence; text distributed to participants)*



Jan Trzuszczński

*Director-General for Education, Training,
Culture and Youth of the European
Commission*

Ladies and gentlemen, let us move to our closing round. We have three particularly distinguished speakers: Mr Marco Buti, Director-General for Economic and Financial Affairs at the European Commission; Professor Fritz Breuss from WU Vienna; and Viscount Etienne Davignon.

We will start with Director-General Marco Buti, who just led the panel some moments ago and now wishes to share with you some final remarks, observations, thoughts, and ideas.

Closing remarks

Thank you very much Jan. We are on a fire-fighting mission, not only every day but every moment of the day. Often, for obvious reasons, we are fighting like '*pompiers*' and perhaps do not pay attention to the broader picture. This is perhaps an occasion to lift the eyes from the ground and look forward. One has to acknowledge that, as has always been the case in the past, European integration has really been forged during periods of crisis; the leaps forward have been made when the threats were greater.

We are now in one of those periods. Momentous changes are taking place, and the fire-fighting is going hand-in-hand with wide fundamental reforms. Obviously, one can turn the case on its head. I think that we are going to be in relatively good health in the longer term. The firefighting is for that; now.

What is the task at hand?

I think the task at hand now is to break the vicious circle between the sovereign debt crisis, financial banking and stress and economic activity. At the moment we have this vicious circle and we need a circuit breaker, or several circuit breakers. This is the challenge in the very short term.

Then there is a challenge in the medium to long term, and here in economic terms, this is related, in my view, to the nature of the crisis I alluded to in my previous intervention. This is not an ordinary crisis. It is not only a deep one, it is a crisis leaving a long-lasting legacy. So the scars in the economic tissue are going to be quite deep and long lasting. In the economic literature, this has been essentially driven by Kenneth Rogoff and Carmen Reinhart, who



Maro Buti

Director-General for Economic and Financial Affairs at the European Commission

have analysed the effects of financial crises in the past, and what you have here following the financial crisis is the need for a deleveraging of the private sector, and on the public sector it will lead to a period of subdued growth for a while. If one looks at the current recovery it is more moderate than it has been in the past. Obviously this is not a fatality. It means that we have to devise our policies so that we can tackle these long-lasting and deep-rooted problems.

To summarise, what we need is that we cannot afford here to have a separation between the firefighting in the very short term and what needs to be done in the medium to long term. We cannot afford to say that now we are not bothered about growth in the longer term. From an economic policy perspective, we have to combine the two. This is very clear, and also the markets have realised that and they are pushing for that. What one has seen in the last year is that credit-rating agencies are looking at the spreads and the attention has shifted back and forth between fiscal consolidation and putting public finances in order. When countries have taken measures to reign in budget deficits, the markets have said yes, but where is growth coming from? So there is a need here to combine the short term with the medium to long term. For the medium to long term, we know what needs to be done for Europe; there is no surprise here. We have put forward and analysed this for many years. From this point of view the crisis has not changed fundamentally. The same priorities remain as those which were identified before the crisis. But what the crisis has done is that it has made all these changes more urgent.

For the medium to longer term, we have the agenda of Europe 2020, and the Commission has come out two days ago with the kick-off of the second European semester with the annual growth survey, where we indicate the priorities that should be pursued in the next 12 to 18 months, and these are the classic recipes that we have advocated for several years to boost potential growth, structural reforms boosting productivity and so on and so forth.

As part of the systemic response, there is also the institutional dimension. We have clearly realised that we are much more interconnected than we thought. I think as economists we have responsibility here. When in the pre-crisis period we had to address the spillover in other countries, our models gave relatively little impact. So these are

not standard macroeconomic models. The crisis has shown the degree of interpenetration that we have on the global level, and I mentioned before the extremely high correlation of growth across the globe and the fact that we cannot count on the decoupling of any sort. But in particular with the euro area the degree of interconnection is very high and the fact that a small country like Greece can have systemic implications for all the others clearly points to the need to have a systemic response, and part of the systemic response is the reform of economic governance which we are pursuing right now.

The Commission has come forward a few weeks ago with a roadmap for growth and stability. It has essentially four points dealing with the Greek problem and with other vulnerable countries. Secondly it is building credible firewalls by strengthening mechanisms. The third point is that it is strengthening the banking system, both in terms of recapitalisation and in terms of access to funding. Finally to reform and deepen economic governance.

The crisis helps to focus attention and helps to overcome redlines and to remove resistance that has been there for decades. What we have been able to achieve in the past 2 years is actually extraordinary at the level of the management of the Union and the euro area. Again, once we will be beyond the tunnel of the crisis and we have to put all our energy now in the next weeks leading to the European Council on the 9 December. But once we will be out of the tunnel of the crisis I think that we will be left with an institutional architecture which is considerably stronger than what we had before.

We have been fighting for decades to strengthen the coordination and the supervision of financial markets. The Council and the Parliament have adopted a supervisory package with the supervision of the European authorities for the creation of a European system. Again it is not the final step or the final solution, but it is very important progress in making sure that we have better control of financial markets and so we will spot future crises much earlier. On this there was a full blockage for many many years; we could not talk about that. But the crisis has helped to remove this.

Second, we have reformed the Stability and Growth Pact. In the past this pact had the problem of enforcement and a new reform

that is going to be implemented as soon as it comes into force in mid December, has strengthened very substantially the enforcement mechanism of the pact.

We have adopted a new so-called 'excessive imbalances procedure'. In the past we have put exclusive attention on the public finances. There is an issue of internal imbalances within the euro area which has to be tackled and will be dealt with this new surveillance.

We have come out today with proposals on strengthening the budgetary surveillance and strengthening the surveillance for vulnerable countries. There are two proposals for the euro area under Article 136, which is the one new article in the Lisbon Treaty which allows stronger coordination of euro area countries. And we have come forward with a Green Paper on eurobonds which puts forwards ideas and makes an assessment of pros and cons of moving to eurobonds. In this stage of the crisis there has been quite a lot of reaction; we knew it was controversial, but we knew also that we had the right and the duty to put forward ambitious proposals. We are going to have a short period of consultation on that and we will draw up the concrete proposals later on.

As I announced in my previous speech, we are going to come out before the end of the year with a communication with proposals of a roadmap towards a unified representation of the Union and a euro area in global form.

This was just a brief picture of what is ongoing, and if one takes a bit of distance from the urgencies of everyday and compares this to the kind of system of surveillance and coordination that we had before the crisis, I think this is a very important change. Even if we are only in this period, trapped in intergovernmental temptations with directorates and countries taking the lead and not always being very supportive of *la méthode communautaire* which has allowed us to progress over the last 50 years. What actually comes out here is a considerable strengthening of European institutions and I think we are going to be better equipped to deal with the forthcoming problems and the very formidable challenges with a new institutional architecture than we were before the crisis.

Jan Truszczyński

Thank you Mr Buti. It is comforting to hear that in all this firefighting we are not losing sight of the wood for the trees. We are able to look further afield and consider solutions, not only consider but also propose solutions, to create a better and more efficient architecture for the future.

We now move to our next speaker, Professor Fritz Breuss, who is at the Business Institute für Wirtschaftsforschung. Beyond his academic research in this institute focusing on the field of European economy, where he leads the academic unit on European economy, he has been visiting professor overseas at Berkeley. He has also been visiting professor elsewhere in Europe, including at Cambridge University, but his main base is Vienna and his main subject remains European integration. He has kindly agreed to give this conference speech to us.

Euro crisis as a chance for a **restart** of the European Union



Fritz Breuss

Professor at WU Vienna

If the euro survives the EU will also survive

Economic and monetary union (EMU) of the EU with the single currency euro is the most ambitious integration project in Europe after the customs union and the single market. A single market only functions properly if all Member States can participate under the same rules of the game. Also the elimination of exchange rate uncertainties is an important ingredient. This ambitious project, however, came to a halt. Out of 27 EU Member States only 17 countries are members of the eurozone. EU's single market, therefore, is split into two blocks, in a group of countries with the euro and countries which can still disturb the single market by devaluing against the euro.

Due to the unfolding debt problems in some Member States of the eurozone in the aftermath of the global financial and economic crisis as of 2008/09 one can hardly expect a fast expansion of the eurozone. On the contrary, one could rather expect a downsizing of the eurozone if the problems of indebtedness and the absence of competitiveness in the periphery countries cannot be solved quickly.

A breakdown of the eurozone would imply a bad setback for the perception of Europe in the world. The euro is the 'face of Europe'. Returning to the national currency muddle would marginalise Europe and the EU in the international political and economic power play (globalisation). The EU's single market could no longer deliver its full integration potentials. Therefore all efforts are welcome which eliminate the constructional flaw of EMU, which was revealed mercilessly by the crisis in 2009. More Europe is needed — not only

in the monetary policy, but also in the area of economic and fiscal policy (fiscal union). In this spirit the euro crisis could be a chance for a restart of the EU via a reform of the EU Treaty.

If one airily names the sovereign debt crisis in the eurozone as a 'euro crisis' one should not forget that we do not have a 'crisis of the euro'. An obvious piece of evidence is the fact that the euro exchange rate vis-à-vis the US dollar did not 'crash' when the Greek crisis broke out in May 2010. In contrast, since then it fluctuated within a band of USD/EUR 1.30 to 1.50.

The 'construction flaw' of the eurozone

EU's EMU has been grounded on the wrong principle, namely on the idea of 'one market, one money' (this was the title of a comprehensive study commissioned by the European Commission in 1990). Normally, monetary unions function on the principle 'one country, one money'. History tells us that there was no functioning monetary union based on a union of independent states. A bad omen for EU's EMU is the famous undertaking of the 'Latin Monetary Union', which existed from December 1865 until 1914 or until December 1926. Greece was also a member of that monetary union, which in the end failed.

The European Union is — according to the judgement of the German Federal Constitutional Court (Bundesverfassungsgerichtshof) — only a 'union of states' (Staatenverbund). Therefore, the Eurozone, with its 17 Member States, works on the basis of an asymmetric economic policy architecture. In contrast, the US's economic policy acts symmetrically. In EMU the centralised monetary policy goes along with a decentralised economic (fiscal) policy. For the time being, EMU therefore consists only of the 'M', monetary, but not yet of 'E', an economic union. In order to have a functioning monetary union, in the end it would need a 'political union' (which could not be realised in 1998 because of the British veto) and lastly the 'United States of Europe' (USE).

Lessons learned from the crisis

Since 2009/10 the EU's EMU has undergone its most severe crisis. It is not so much that the euro is in danger, but that some Member

States of the eurozone are at the brink of national insolvency because of indebtedness and lack of competitiveness. The construction flaws of EMU and its policy design have been revealed crystal clear by the crisis in the eurozone, triggered off by the stark indebtedness in some periphery states of the eurozone in the aftermath of the Great Recession as of 2009 and due to the drifting apart of competitiveness between the Member States. The great shock of the crisis taught us what we must improve in economic governance in order to be able to cope better with future shocks and to give the eurozone a chance to survive.

The following policy areas exhibit imperfections/weaknesses and lack of adequate policy instruments.

- 'European business cycle': Despite the hope at the beginning of EMU we still lack such a thing. However, a common European cycle would be a prerequisite for a functioning common monetary policy working with a single interest rate for all Member States of the eurozone. The single nominal interest rate in the eurozone translated into different real interest rates due to diverging inflation rates in the Member States. This led to misallocation of capital. In those countries (in the periphery or in the PIIGS — Portugal, Ireland, Italy, Greece and Spain) which had to adjust their high interest rates to the lower eurozone level at entry into EMU the low interest rate policy led to wrong signals to investors and consumers in the private and public sectors and hence to misallocation and to an unnatural indebtedness.

Since 1999, the diverging capacity to adjust to the needs of a single currency (the loss of the instrument of depreciating their national currencies) led increasingly to a drift apart of competitiveness (measured by unit labour costs relative to average eurozone values or real exchange rate). The countries of the former hard currency or DM bloc in core Europe — in particular Germany and Austria — improved their competitiveness whereas the PIIGS lost theirs. Before the start of EMU the latter countries always corrected the weaknesses in their current accounts by depreciating their currencies against that of the hard currency bloc. Unfortunately, the PIIGS did not learn how to cope with the new situation of a single currency — they were not ready to depreciate 'internally', i.e. to adjust

wages to the development of productivity (productivity-oriented wage policy).

- Centralised fiscal policy (fiscal union): It would be important to have a stronger centralised fiscal policy at EU level as pendant of the already centralised monetary policy. Up to now the 'centralised fiscal policy' was only emulated or simulated via the coordination exercises of the Stability and Growth Pact (SGP). These efforts were not credible — not least because it was not respected, even by France and Germany in 2003/04, and circumvented twice by data manipulations in Greece; in addition its violation was never sanctioned. Hence, hitherto the SGP was not binding and inefficient.

On 13 December 2011, in order to improve economic policy governance, the 'six-pack' (with five regulations and one directive) was put into force. Three regulations and one directive aim at reforming the SGP (SGP III); two regulations deal with the surveillance of macro-economic imbalances.

- SGP III: On 23 November 2011 the European Commission proposed, in addition to the legal foundation of a stronger surveillance of fiscal policy in EU Member States under SGP III (better *ex ante* control; direct supervision of the dynamic of public debt; rules for improving the statistics of nation state budgets; quasi-automatic sanctions), two new regulations: one for a stronger monitoring of national budgets for Member States in the excessive deficit procedure (EDP); and the other on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area, i.e. countries under the 'rescue umbrella' receiving financial assistance from the EFSF (European Financial Stability Facility), the ESM (European Stability Mechanism) and/or the IMF.

These measures are based on the Lisbon Treaty and hence are rules within the 'Community method' which are welcome as a good step further to improve 'economic governance'. However, they are only — even so — a tighter 'simulation' of a centralised fiscal policy at EU level employed up to now.

(b) EIP: In addition, the 'six-pack' provides for the first time two regulations which explicitly deal with the hitherto rarely considered macroeconomic imbalances. Since 1999 these imbalances (measured by unit labour costs relative to the eurozone average) have grown steadily greater. The big winners of this competition race (Germany and Austria) within the eurozone stood face to face with the PIIGS as competition losers. The fact of the drifting apart of competitiveness in the eurozone (or the non-converging towards a 'European business cycle') can also be seen as a falsification of the endogenous 'optimum currency area' (OCA) theory. This theory postulated that after the introduction of the euro the intra-eurozone trade would be intensified and hence would contribute to the harmonisation of the European business cycle.

The Commission monitors the aberrations of competitiveness within the eurozone under the excessive imbalance procedure (EIP) using a scoreboard with a set of indicators identifying and monitoring imbalances (e.g. current account, real exchange rates or relative unit labour costs, etc.).

The EIP is no more than a copy of the EDP as part of the SGP. Whether sanctions against Member States with high current account surpluses (Germany and Austria) will ever be imposed is an open question. In principle, current account imbalances should be treated symmetrically. Surpluses and deficits are imbalances. In courtesy to countries with current account surpluses the Commission defines as imbalances only current account balances outside the range of -4% and $+6\%$ of GDP. Therefore, Germany would not (yet) be subject to sanctions.

A single market for government bonds

One of the great challenges today is to calm down the financial markets and to convince the rating agencies, as well as to recover the trust into government bonds of eurozone Member States. Last but not least, the task is to mitigate the spread of government bonds of eurozone Member States, which have increased dramatically since 2008. As a target they should shrink to values which we saw during the 'fair-weather period' of the eurozone, namely

during 1999 to 2007. In this phase we had practically a 'virtual' government bonds market in the eurozone. The spread of 10-year government bonds vis-à-vis Germany was very small because the investors believed — contrary to the 'no-bailout' clause of Article 125 TFEU — that in case of troubles the euro area Member States would mutually guarantee each other's debts. In addition, Basle II (and also Basle III) classified government bonds as risk free; regardless of which Member State issued them. Earlier we stated the 'construction flaw' of the eurozone in the lack of a European statehood (like the USA). The governments of its Member States issue bonds (for which they alone should provide a guarantee) in effect in a 'foreign currency', the euro (which is issued by the ECB). This contradiction explains the current scepticism of international investors vis-à-vis government bonds of unstable Member States of the eurozone.

Crisis or stability funds

In 'fair-weather periods' the 'no-bailout' clause fulfilled its purpose. When the big crises (sovereign debt shock after the global financial and economic crisis 2009) hit the EU and the eurozone there were no instruments to face the crisis. After the Greek crisis broke out in spring 2010 one had to act ad hoc — also with the help of the IMF which already had such instruments to manage crises in developing countries. 'Rescue umbrellas' had to be opened which ended in the EFSF and lastly in the ESM. Three countries (Greece, Ireland and Portugal) are already under the 'euro rescue umbrella' in one way or another: Greece with bilateral credit actions of the partner Member States of the eurozone; Portugal and Ireland with a common rescue package involving loans by the EFSF, the EU (EFSM — European Financial Stabilisation Mechanism) and the IMF.

What would neat solutions look like?

Two years of rescue efforts barely mitigated the euro debt crisis; it did not appease the financial markets, and we still have no definite solution for the sovereign debt crisis. This poses the question: how long we can delay neat solutions by simply 'muddling through' the crisis. The sovereign debt crisis in the eurozone, triggered off by the Greek shock in May 2010, revealed the problem of different

velocities. The financial markets act fast and drive the policy before it. On the one hand, there were no crisis instruments at hand on the basis of the 'Community method'. Therefore, at every new crisis summit the Heads of States or Government had to decide 'inter-governmentally'. The solutions were ad hoc ('rescue umbrellas') because no instruments were at hand or because solutions were restricted by the rules of law of the Lisbon Treaty. The crisis showed that the Lisbon Treaty entered into force on 1 December 2009 and is already obsolete in areas regulating EMU. A reform of the EU Treaty — or a 'restart of the EU' — is urgently needed in order to get neat solutions for a frictionless functioning of EMU, also in times of a crisis. Only with such 'neat solutions' would the EU approach the ideals of 'one country, one money'.

The following legal barriers must be broken down or regulated in a new EU Treaty in order to get a functioning EMU.

- Fiscal union: The initiated foundation of a 'fiscal stability union' (fiscal union) by the euro area Heads of State or Government at the summit of 9 December 2011 — based on a proposal by Merkel and Sarkozy — will be enshrined in a 'new fiscal compact', for the time being only an intergovernmental treaty. Because of the British veto these new fiscal rules could not be realised by a reform of the EU Treaty. A stronger centralisation of national fiscal policy at EU level (stronger policy coordination) should be achieved by new fiscal rules: stricter budgetary controls; stronger intervention into national budgetary law; debt breaks in the Member States of the eurozone, implemented at constitutional or equivalent level; and 'automatic' sanctions.

However, this process of 'fiscal policy centralisation' is optional because the new fiscal compact runs outside the EU Treaty and hence is again an example of crisis management outside the 'Community method'.

Unfortunately, in the 'Merkozy' proposals, no provision is allowed for the implementation of a system of 'fiscal federalism' like in the USA and in Canada. With such a system business cycle imbalances

between Member States of the eurozone could be mitigated by fiscal compensation. Again such a mechanism would need a reform of the EU Treaty. Nevertheless, the planned 'fiscal union' is a step in the right direction. I would transform the asymmetric economic policy design of EMU towards a more symmetric one which would then resemble more those of the USA. With this step we would gradually add the 'M' (monetary union) also the 'E' (economic union) and would become a true EMU.

- The ECB receives enhanced competences as 'lender of last resort' (LLR): This would need changes to Article 123 TFEU. Today the ECB is only allowed to buy government bonds on the secondary market to stabilise the bond market. It could already now do this with more rigour and credibility to signal to the financial markets that it is able to stabilise the bond market at any time. For the time being it fulfils the LLR function only vis-à-vis banks. Nevertheless, the ECB is the only institution which is able to react to a crisis very quickly. See for instance its policy change in December 2011 to prevent the current banking crisis in Europe. With non-standard measures it provided the European banks with liquidity with a maturity of 3 years by a longer-term refinancing operation (LTRO).

The sovereign debt crisis, starting on the periphery (Greece, Ireland and Portugal), spilled over more and more to the core of the eurozone. This initiated a capital flight, also in France and Italy. The balance of this capital flight by printing money by national central banks should be regulated, similar to the procedures in the USA within the Fed system (Hans-Werner Sinn). In the USA, regional central banks must pay their special money printing with gold-covered bonds. Such an American way could be arranged within the European System of Central Banks (ESCB).

- A single sovereign bond market: The current large spreads of government bonds of Member States in the eurozones will be narrowed only if confidence of financial markets in sovereign bonds even from peripheral countries is restored. Maybe we are able to come back to such small spreads as in the 'fair weather period' of the eurozone (1999–2007).

Eurobonds

'Eurobonds' — in whatever variant — could be an instrument to harmonise the sovereign bond market in the eurozone. Because they imply a mutual guarantee between Member States of the Eurozone, a change to the 'no-bailout' clause (Article 125 TFEU) would be necessary. Beyond these legal restrictions, at the moment eurobonds are hardly enforceable politically because they would be unfair to stable countries. Triple-A countries which currently pay low interest rates on government bonds would have to pay higher interest rates because the indebted crisis countries drive up the average interest rate level for eurobonds. In Germany, for example, the interest rate for eurobonds would be higher by 2 to 3 percentage points than that for German bonds, which would increase the burden for the national budget by EUR 40–60 billion.

Logically, eurobonds are only feasible in combination with a real 'fiscal union' or when a 'European finance minister' is installed. Eurobonds are only credible for international investors if they are issued and guaranteed by an EU institution instead of — as the practice is now — by Member States of the eurozone. The 'rescue umbrellas' of EFSF and ESM are only an emergency solution.

EMF

It is thinkable that the permanent ESM — in the far future — could be transformed into a 'European Monetary Fund' (EMF). However, this would also entail a change to the EU Treaty because this implies a mutual guarantee of Member States and, currently, would therefore be an infringement of the 'no-bailout' clause. Furthermore, the EMF would not only be applicable to the Member States of the eurozone but to all 27 EU Member States.

Downsizing of the eurozone: My wish would be a new Article 50a TFEU which would allow one Member State zone temporarily to exit the eurozone for the purpose of economic recovery. Currently only the withdrawal from the EU and hence also from the eurozone is governed by Article 50 TFEU. With such a new Article 50a one could resize (downsize) the eurozone according to the criteria of the OCA theory.

Because this is excluded from current EU law and also politically not welcome, we must keep alive artificially the politically desired 'large' EMU with 17 Member States by embarking into a 'transfer union' (EFS/ESM). From an economic point of view — and taught to us by the crisis in the eurozone — a 'small' EMU would be optimal, and such an EMU would also be sustainable in times of a crisis. Such a small EMU would be a competitive 'core Europe' consisting of homogeneous economies. Misallocations would be minimised. Interestingly, such a 'core Europe', consisting of some six Member States, would also contain those countries of the current eurozone with a triple-A rating.

The euro will also survive with the 'transfer union', but will be more costly and inefficient than a 'core Europe' solution.

- 'Exhausting' the existing Lisbon Treaty: Before we enter into tedious negotiations about the chances of the EU Treaty which are not easy and time-consuming when it comes to ratification (see the last veto by Great Britain), one could 'exhaust' the rules of the Lisbon Treaty. This is exactly what the European Commission is doing with the implementation of the 'six-pack'. One could also think of crisis solutions *à la* Schengen, i.e. with the instrument of 'enhanced cooperation' (see Article 326 ff. TFEU).

Political collateral damage from the sovereign debt crisis

The EU, and the eurozone in particular, also slipped into a crisis of democracy due to the 'euro crisis'. On the EU level the crisis inter-governmental management by the Heads of States or Government marginalised the European Parliament and the European Commission, and at national level many governments of the eurozone collapsed because of the burden of debt stabilisation which was too big for them to manage.

Division of the EU and of the Eurozone: In the EU we already have areas of a division of integration or forms of a 'flexible integration' like Schengen and EMU, but the current crisis will intensify this split in the EU up to a constellation of a 'two-speed Europe, or two

Europes' (as in a headline from *The Economist* recently). The best example was the summit of the European Council (8 to 9 December 2011) where the veto of Great Britain prevented the attempt to reform the EU Treaty. As a compromise solution the planned 'fiscal union' will be regulated in an intergovernmental 'new fiscal compact'. There are many other political breaking lines.

- Eurozone versus non-eurozone: The eurozone carries on heading to a new institutional set-up, the countries of the non-eurozone fall behind. The latter also do not help in the current 'rescue operations' for Greece, Ireland and Portugal.
- 'Merkozy' versus the residual Eurozone: Within the eurozone there is a special split between 'Merkozy', i.e. between France and Germany, who push ahead with proposals for reforming EMU, and the residual, mostly small Member States — the latter only can rubber-stamp what 'Merkozy' proposes.

- (1) Variable speeds: The crisis also revealed the different 'speeds' by solving financial problems and political solutions at EU and national level. The financial markets (which are very fast) kick the policy (which is slow because it has to take into consideration democratic (parliamentary) rules).

In case of crisis management, therefore, the fast method of 'intergovernmentalism' has priority over the 'Community method', which is in the foreground in normal times (see EFSF/ESM, Euro Plus Pact, fiscal compact, etc.).

- (2) Probability of political implementation: In the course of the euro crisis the general scepticism vis-à-vis the EU and the euro has increased in many EU Member States. This poses the question whether the population in any Member State is willing to accept large changes in the EU Treaty. In Finland, the political party of the 'True Fins' won at parliamentary elections in April 2011 17 % of the vote, compared to only 4 % in 2007. In Austria the Freedom Party (Strache) are fuelling worry about the euro rescue measures with the slogan 'Our money for our people' (Unser Geld für unsere Leut).

- (3) Crisis of democracy and of the European welfare state: During the euro crisis since early 2010, the governments or prime ministers in at least five Member States of the eurozone have had to resign: Estonia, Greece, Ireland, Italy and Slovakia. In Greece and Italy the professional politicians were overwhelmed in view of the challenges of stabilising their indebted economies. Therefore they were substituted by 'expert governments' (with economists). In a transitional period they should stabilise the national budgets with austerity measures and at the same time manage to stimulate economic growth. After that, ordinary politicians elected by the people will take over again.

In the context of stabilising the budgets, more and more cuts are targeting outlays for the welfare state (social programmes). Anyway, the very generous European 'social model' is at stake. However, we know at least four different social models in Europe: the Nordic, the Continental, the Anglo-Saxon and the Mediterranean models.

Conclusions — EU and eurozone in 10 years

If we manage to create the 'fiscal union' (with stronger controls on national budgets, debt brakes and eventually by installing a 'European finance minister') initiated at the December 2011 summit, we would be well prepared for future debt crises. In 10 years' time, the 'new eurozone', which will probably be comprised of more than 17 Member States, could be transformed into a 'true EMU' with also a functioning 'E', i.e. also an economic union. Then one would also have new crisis tools like eurobonds, a European Monetary Fund; a more engaged ECB and an ESCB similar to the Fed practice in the USA. Long- and short-term interest rates would mirror the true creditworthiness of countries; financial markets would act as a real corrective in case of indebtedness and misallocation of capital.

In addition, if the peripheral countries with weak competitiveness realise (mentally and politically) that an adjustment to a single currency (internal depreciation) is urgently necessary, it would make sense that the EU stimulates economic growth in these countries with its new growth programme 'Europe 2020'. As a good European, one would then generate hope that instead of all troubles

we would be able to present with the euro the 'face of Europe' as a proximate entity of Europe in the world. The euro will survive also with the 'transfer union', however at higher costs and less efficient than with a eurozone consisting only of 'core Europe'.

Jan Trzuszczński

Professor Breuss, thank you very much for your contribution. I listen to it carefully and it seems to me that you knew in your short contribution how to discuss all the main problems which we face. Whether, when and in what form we will solve these problems — at once or step by step — this question remains, of course, open, but this conference contributes significantly to finding the answers.

Now, let me announce with particular pleasure our third speaker for this round, a speaker who does not need an introduction. Nonetheless, it is my pleasant duty to tell you that Viscount Davignon, with his time-honoured and distinguished career as a European diplomat, European politician and European businessman, remains one of the thinkers driving forward European integration and European thought. I think that we can all be honoured to have him here with us, and I myself am very much looking forward to the thoughts he will be sharing with us today.

Closing remarks

I will do my best to bring out what has changed and what has not changed.

There is a permanent red threat in the European Union: we are always surprised when what we have forecast happens. I cannot remember for how many years we have been forecasting that if you do not have a better balance between monetary issues and economic issues, a degree of discipline and a combination of implementation, things will be difficult. And now things are really difficult, so we are surprised. The annoying thing is that we are also surprised by things we had not anticipated or not anticipated quickly enough.

Personally, I see one really major change compared to other crises which we usually manage to get out of. As Mr Buti said, we usually leave crises better than we went into them. This time, the major difference is that the market has been invited within the debate. Markets have always been there but they have never played the same type of role as they play today. Let me give you three examples. The markets did not see the financial crisis of the United States happen, they did not anticipate it. The markets, literally, had to wait for the consequences of the banking crisis to suddenly discover that sovereign states are, from an investor's point of view, in the same position as any other power. That was completely new. Secondly, sovereign debt was the secure investment of banks. How did you use with tranquillity part of the money that savings have brought to you, put in something that was not highly attractive from the revenue point of view, but had very liquid risk. Now, this situation has changed. The third



Etienne Davignon

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element which has come about is that the timing and the necessity to react in time are completely different between what democracies can do and what markets want. I deliberately use the word 'democracy' because for me democracy is still something important. The leaders of our countries are not necessarily stupid and they don't necessarily do what they shouldn't.

So, I am speaking about democracy. This is completely different and I will give you one example, the example of the EFSF. If one year ago anyone had prognosticated that de facto you could draw up 17 bilateral treaties, get them ratified by a parliament and get a new set of instruments, everyone would have said that was completely impossible. It was done in 3 months. What did the markets say? The markets said on the morning of the decision 'this goes in the right direction' and in the afternoon 'they won't do it'. So we are confronted with a formidable double gap of credibility in the implementation of what is decided. And that is what we need. We need the combination of credible measures to offset the absence of trust on what has been decided, simultaneously we must decide on firefighting.

So, let us see which instruments we have to deal with that. Here we draw a comparison with the instruments we had before the existence of the monetary union. The one formidable difference is that the institutional powers of the eurozone are completely different from the institutional powers of the Union as a whole. This of course creates an enormous problem of the credibility on what the European eurozone's ministers and Member States decide. I will not go into the debate about '*la méthode communautaire*' and the intergovernmental approach because it produces no solutions to this problem today. We have to do what we must with the tools that are available to us. We have to do it in such a fashion that at the end of the day, the institutions will in any case be strengthened. And how does that happen? There are a number of avenues through which this can be done. Nothing would be worse than having an ideological debate today over '*la méthode communautaire*' in comparison to what pragmatically you can do, because there is nobody to give you an answer.

When I hear 'treaty change' one part of me is delighted: at last we have found out what the structural failures are, at last we will

be logical with what our purpose is, and we will have the institutions we need to meet our purpose. Then I stop and look, and I see that this brings out two fundamental debates, both fundamental debates that we have never solved. The relationship between the 17 and the 27 is at the heart of this issue. We have always known that the consequences of having a monetary union meant that Member States had more commitments than those who were not in the monetary union. More necessary commitments, and also more instruments which give credibility to these commitments. That's a formidable problem.

The second problem is that we have never had a treaty change except the very small one we made in order to meet the Council's concerns. The problem is that when you start with a treaty change (I personally have seen quite a few and some of them quite useless) it becomes a shopping list. Everyone adds what he would like to have. If you are in a crisis, you are not in a discussion on what it would be nice to have, but you are in a discussion on what it is necessary to have. What you need to have is by definition a selection of priorities, and when I hear 'treaty change' I'm extremely concerned. When you add the consequences of the mismatch between the democratic timetable and the market's timetable, then I'm afraid that, to take Mr Buti's comparison of getting out of the tunnel, we will find that in the middle of the tunnel there is something which does not allow us to get out. Suddenly, in the middle of the tunnel, you find an iceberg and you bump into it. Then it is difficult to go back and certainly not possible to go further, so be careful with the metaphors.

Then you come to the fundamental political issue. What is needed to get a credible consensus? A credible firefighting, a credible dissuasion, a credible managing of the dominos, and the need for the medicine to be not worse than the crisis. If you look at this very clearly, a few fundamental elements emerge. I will make my observations without having a ranking of different elements because, in my view, you need all of them. The first one is the Member States. The Member States do not have a credible programme to put the house in order in relation to what has been excessive, and the absence of structural reforms. Then, no market will believe anything because there will always be a scenario where what has to be

saved goes beyond the means of those who would like to save it. Therefore, it starts with Member States. With Member States are we in a position which makes that impossible? I believe no. It is perhaps the one element on which I am less pessimistic. Why? Because public opinion is fundamentally worried, afraid of what it has, afraid of what will be and quite conscious that the risk of the status quo is much greater than the pain of the change.

If you look at the three last events in Greece, Italy and Spain, it goes in that direction. The voters in Spain know that the new majority they have given a mandate to will have to do what is necessary, and what is necessary is not very different from what was necessary the day before the elections. Mr Monti, who I expect would have been here if Mr Napolitano had not had other ideas for him, would be saying things which are reasonably comparable to what I am saying. There is also the combination that fright leads to hope. Is that enough to get things done? No. Is it enough to start? Yes. The Greek situation, with the final approval of the party which is still the minority party in Greece of voting for the measures, is the indication for that. That vote having occurred, there were not more people who went out on the streets than before. But will it last?

Can the Member States do this alone? The answer is no and I'm not speaking about finances and help and so forth. I am speaking about what they need to do to convince their people that what they are doing is going in the right direction. And here they need the European Union, in particular the Commission, and the Commission today has more powers than it had before. These are powers of the institution and for the last 2 weeks we have been seeing the Commission using its instruments. And that is a good thing, indispensable for Member States, because here you must look to the back to the creation of the monetary union.

The monetary union was the perspective. To get the monetary union, states have to put the house in order, and a number of Member States had to put their houses in order. I take two simple examples, my own country and Italy, and we did it. We would never have done it if there hadn't been that perspective. People accepted it because they knew what the political, financial, economic and social consequences would be if they were left out of the monetary union.

So you absolutely need the intervention, and I use the term of the institutions of the Union because it gives a quality guarantee which nobody else can give today. You know the rating agencies and so on. What guarantee can they give? When I look at the difference of the spread between countries which are triple A and countries which are not triple A, all that has disappeared. The markets have decided what risk they are ready to take or not take.

The combination of the institutions and the Member States is very important. Firstly, because if that does not exist, you do not have a basis for anything else. Second question: firewalls, intervention, ECB, eurobonds and so on and so forth. All of this represents a technical answer to a fundamentally political question: Is there a degree of mutualisation which is the consequence of the monetary union? On the one hand, if you have a monetary union, you cannot take your decisions on your currency. If you have a monetary union, you cannot do that, but then what does the monetary union bring to you if you are in trouble? So the fact, leaving aside that it is of mutual self-interest to do it, is that it is structurally part of the system. We have begged the crucial question: 'what conditions have to be created for the Member States of the monetary union to accept this type of mutualisation?' I have not gone into the details of what it can be but this is the crux of the matter, when I look at my different fundamental points.

It is necessary for the European Central Bank and the countries which are in excess to be sure that the mutualisation is not the disappearance of the responsibility of the concerned parties. That is the crux of the political debate. Yes, but if we do this that means that my first point, Member States before, after and during, do not have to do what they want to do because they are secure. They are secure to an extent which the markets will not believe, but the way in which they are secured is credible and feasible. And it is fascinating to see how the questions of political unification have come back on the table.

For an old observer of European affairs and sometimes even an actor, it is fascinating to see that political union was a politically incorrect word to use. When you said that monetary union will lead to political union, you were speaking the language of the anti-British Europeans, 'you see they are going to do it'. And what did the

pro-European say? 'No, no we are not going to do it'. This is not a caricature, this is the reality of what came across in the media, in the seminars and all these fascinating things that we do together.

Today one speaks of political union as part of the guarantee that the mutualisation will not be misused. You see Monsieur Juppé on television saying that the economic governance of Europe has to have some sort of federal content and he is a historical Gaullist. Having known the General, I don't think he will recognise himself in an element of federalist financial affairs. Was he shot down after having said that, either in his party or outside his party? The answer is no, so again, that is where I totally agree with what my two colleagues on the platform have said. The depth of the crisis has allowed for the reopening of boxes which have been shut for a long time. Is it enough to open them? The answer is no. But in the gloom and pain it is important to see where the perspectives are and where the debate is on what are the political requirements.

Third point: *directoire*. It is clear and certain that if you want to achieve one and two, it is totally impossible for the other countries to believe that they are governed by one or two countries and not by the institution. This is not a forecast, it is a certainty. Will people not do intelligent things for bad reasons? The answer has always been yes. But the political exasperation which is very close to being high is something one has to take into account for a conjunctural reason and for a structural reason. The conjunctural reason is that the Franco-German proposals have not worked. If you apply for a post, you must show your credentials and if your credentials are bad you won't get the post. If your credentials are good, maybe you will. Today it has not worked, period. So it is very important that what comes out of 8 December is something which includes the participation of everybody, but the domination of no one.

I have lived the Franco-German relationship in my active career since 1961. It has never been what people have written about it and what it was. Let me take three very simple examples of what are the legends of the European Union. The friendship — and I use the word friendship rather than political understanding — between Giscard and Schmidt started when both of them were no longer in office. This is a fact. Let me mention an anecdote.

We were holding a summit in Brussels. The summit was supposed to start at half past nine and at a quarter to ten the French and the Germans were not there. So the interpretation was 'they are having a *“colloque singulier”* and they will only come when they will agree'. Knowing what had been the preparation of the meeting I was rather worried, because I thought that it may be that they were only going to come at 6 o'clock next morning. So what did I do? I went out and I asked the security people to tell me where the French and German delegations were. The French delegation was in its car outside the French embassy; the German delegation was stopped, for those who know Brussels, on the Avenue de Tervueren. What were they waiting for? They were waiting to be sure that the other one got there first, because both of them wanted to arrive last. That is the indication of true friendship, total trust!

It has always been a fact that if the system is blocked and if there is an agreement between the French and the Germans, the system is not blocked but the decisions are not necessarily taken. Necessary but insufficient, and that is what we have to deal with. This is, of course, made more complicated, not by the existence of a chairman of the European Council, but by the fact that it is the European Council which is the place of all final decisions. That means that the preparatory structure on questions like this, on which the credibility of the measure is as important as the measure itself (because that deals with implementation) is properly prepared.

And again, I've lived through the evolution of what was the most significant powerful preparation structure for years and years. It was what we now call the General Council, basically foreign ministers. It changed with the modification of the domestic position of foreign ministers. When they were the number two of their governments it worked; when they were only involved in foreign affairs, it was more difficult. Since one discusses diplomatic issues at the ministries of foreign affairs, it is much nicer to discuss what will happen if Mr Putin gets re-elected as president and so on and so forth. You can have a nice intellectual conversation, whatever you say will change nothing and it is much less difficult than solving proper questions.

So it moved towards the finance ministers with a very significant unnoticed change. The preparation of the finance ministers

followed the same procedure as the preparation of the ministers of agriculture, outside Coreper. Coreper, with all criticism you can level at it, was a preparatory structure where people knew what the remaining questions were which could not be settled without running into political difficulties. So the finance ministers became the most important element of the Union. I'm not saying the budget ministers, but the finance ministers. And since this crisis, because of the domestic political consequences of this crisis, the finance ministers don't have the political legitimacy to deal with these questions without prime ministers and heads of governments.

So what happens then? I'm told from time to time at the finance ministers' discussions (I'm speaking about the euro; I'm always referring to the 17 eurozone countries when I'm speaking of the finance ministers) what happens is that somebody says at some time 'very interesting question but "*Die sind Chefs Sachen*". Finish the discussion, it goes up in all senses of the term, it goes upstairs and continues to go up. This means that the methodology which will be used for implementation of new measures is of a very crucial importance. It can be pragmatic if you don't have the time to make it legal, but it has to go in the direction that it will become legal at a given point. We always had inside the Union what the French call '*la ligne de pente*'. We couldn't get it immediately, but the first decisions we took meant that unavoidably it would end up where it should end up. And the best example of all is Schengen.

Schengen started with an intergovernmental structure but as time went by, to make this structure efficient, it was organised in such a way that it became a Union structure. As a result of the debate between intergovernmental and '*la méthode communautaire*' every time, and I have no memory of any exception, every time when people are really serious and really want something to happen, the only structure which they trust or distrust less is the institutional Union structure. Member States don't trust each other, I'm not sure they trust the institutions but they trust the institutions more than they trust each other. And when they are decided to do something that is the way it goes.

My fourth and last point is on the volatility that we are witnessing today. We have managed with great efficiency to create a situation

by which we are obliging people to do things which they should not do in the present time. Let me explain briefly. After the financial crisis and the banking crisis, three issues: one issue on which progress has been made, regulation and not simply coordination. In any EU decision when you see the word coordination used it means that people did not agree but they are not ready to say so, so they say 'we will speak about it'. Coordination is 'speaking about it' but not having the instruments of decision-making and implementation. We have that progress and the other progress is that one had to create the conditions by which banks could be saved, so that the solidity of the banks was greater than it was before. So the simple answer to that was 'we must see to it that the ratio between what the bank lends and what its own assets are become higher', recapitalisation and so on.

However, all that was discussed at the time when sovereign debt was not at risk. Now that sovereign debt is at risk you have a fundamental problem in banks. They won't recapitalise on the market if they have to meet the ratio and they cannot increase their capital. What do they do? They decrease the lending of the assets they hold and now because of the accounting rules, sovereign debt is held in the same fashion as any other debt, with this extraordinary situation that you suddenly ask yourselves: what is the market value of a sovereign debt?

I'm always astonished that nobody writes about that. If the regulation says that someone who has bought sovereign debt in the European monetary union zone should not have it in the books at the price of the redemption of the debt, you are deciding that sovereign debt is not safe. And so the banks are stuck. Who is selling today? It's not the hedge funds and so on and so forth. The people who are selling today are those who are deleveraging their balance sheet and they deleverage their banking with what they can. And you see pension funds and so on and so forth which cannot take the risk of knowing that you might have to decide that the market value of a debt is something which has to be evaluated by the market. The market can decide what it wants to do on the secondary markets, what it sells and resells, at what interest rate you can buy. That is clear, but the underlying value which is guaranteed by us and which normally has the solidity of the monetary union, you are forcing the banks and the insurance companies to do that.

Something has to happen on that issue because you have, in terms of what is the overall balance, little movement on the markets. When you have little movement on the markets, small volumes create formidable differences. That is what we are seeing today and then you say the consequence is that we will all have to borrow at 7 % and growth is 1 %. So it's clear we are going bankrupt and if we are going bankrupt let's go out and drink champagne and not worry about it. This is really my fourth point. One has to see what one can do to eliminate the vicious circle in which we are. Should banks be more solid? Yes. The way in which in accounting rules the sovereign debt of a monetary union is not dealt with as with sovereign debt of any other country, because you are borrowing in euros and not in another currency, is not a currency risk, it is a substantial risk. We will continue to have the problems we have.

These are my four points. If one can do something about these four points, next year we will be here, speaking about the same thing. If not, next year we will be here but we will not be speaking about the same thing.

Jan Truszczyński

I shall pick up exactly where Viscount Davignon left on the theme of today. I think that the points and insights that he offered during his speech resoundingly confirm how good it was for President Barroso to choose this particular subject for this year's conference: European economic governance in an international context. And more than that, how good it was that the organisers of the conference decided to approach Viscount Davignon, asking him whether he would be available to share his thoughts with all the Jean Monnet professors present here today. I do not know what the subject of next year's conference will be, but of course there will be a conference next year, and I can only hope that the subject chosen for that exercise will be as of much interest as the subject today.

I thank you once again for your participation and for all the thoughts that you have shared with others during this event.

The European Union and the eurozone: is an end to the **crisis** in sight?

Message from Dusan Sidjanski (read by Bruno Boissiere) on 21 November 2011

The European Union and the eurozone are in need of political will, solidarity and a new form of federalism. At a time when the contagion is spreading and markets and speculators are attacking one country after another, the European Union and the eurozone in particular need a global, united response based on the rules and instruments already in place and which bear witness to a great project. A holistic solution which includes eurobonds, the central role of the Commission, the Franco-German partnership and the European Parliament, in line with the recommendations of the Council of Heads of State and Government. This strong message, which reflects the author's own beliefs, is for the citizens of Europe, the markets and the entire world and must be publicised as soon as possible after the European Council of 9 December 2011. The shared European sovereignty of the 17 eurozone states, and, if possible, of the 27 EU Member States, must gain the upper hand over the markets. The European Union's future is at stake.

The financial crisis is the most serious threat to the European Union since the failure of the EDC. In just one year, it has gradually spread through the eurozone, without sparing other Member States of the European Union. The measures taken thus far have not worked. The European Financial Stability Facility (EFSF) and its successor, the European Financial Stabilisation Mechanism (EFSM), have not been equal to the challenge, despite the increase in its resources to EUR 1 000 billion following long negotiations which managed to overcome German resistance to the idea. The slow pace of negotiations between France and Germany and the insufficient means to tackle the public debts of Italy and Spain, not to mention those of France or even Germany, should

be mentioned. This is the original flaw in this intergovernmental mechanism.

The evidence is clear: austerity in line with the German model cuts growth and the purchasing power of German exports, while pushing up unemployment and the dissatisfaction of citizens, encouraging them to take to the streets in violent protest. Furthermore, the crisis has led to several technocratic governments taking office. The outlook is bleak: growth down and the threat of a widespread recession; diverging trends, in particular interest rates for borrowers which are twice as high in France as in Germany, and three times as high or more in Spain and Italy, not to mention the usurious rates charged in Greece!

Budget cuts hit certain groups hard, such as the middle and lower classes, pensioners, and the social, health and culture sectors in particular. At the same time, austerity cuts public investment, which also leads to cuts in private investment and a contracting economy. This, in turn, reduces the ability to honour public debt. Yet, despite these measures leading to recession and aggravating the crisis in society, the German government is insisting on sanctions which should be applied automatically — according to the CDU conference — and the possibility of bringing states that do not respect the Stability and Growth Pact before the Court of Justice.

Should we not concentrate without delay on trying to extricate ourselves from the crisis, rather than obsessing about sanctions? More on positive measures rather than punitive measures or those to facilitate a voluntary exit from the euro without the need to leave the EU? Though we need to address these issues when it comes to revising the Lisbon Treaty, it is more pressing to start with measures to help us stop the negative spiral and start the spillover.

Let us look at the evidence: all the decisions made so far as a response to the markets have ended in failure, to the extent that the crisis is spreading and intensifying. It's a general observation that certain states have taken a long time to recognise.

Admittedly, structural progress has been made and regulatory frameworks adopted by the Council and the European Parliament

on a proposal by the Commission. For example, the six Community bodies to supervise the banks and the insurance industry, systemic risk and securities. As many instruments to support financial activities and prevent crises. However, even these measures are not able to stop the current crisis spreading.

The crisis has exposed both the deep de facto solidarity and the inextricable interdependence of the economies of the Member States. Other issues have also been revealed: the shortcomings of the Lisbon Treaty, intergovernmental drift and the ambiguous role of the Franco-German alliance. With the shock of the crisis have come introversion, national selfishness and the egoism of the financial institutions, populist reactions and a growth in euro-scepticism, posing a threat to our values and democratic traditions, the European model and promises of federalism.

I was struck and dismayed by what Madame Lagarde said at the start of the Greek crisis, placing the emphasis on the loan granted and the profit made by France: borrowed at 2.5 % and lent at 5 %, a sign that solidarity is giving way to gain. More worrying is the spat between the German and Greek media using stereotypes to express the reluctance to help a 'lazy and wasteful people'. This lack of economic solidarity has damaged the European spirit, and to the financial cost has been added a psychological cost, at the expense of the rapprochement of peoples. This negative image of Greece has spread through the media and the public, to the great detriment of European spirit and identity. Whilst the economic damage can be repaired fairly quickly, attitudes die hard and, according to Denis de Rougemont, are the most tenacious obstacles to European integration.

The ineffectiveness of the intergovernmental method, taking us backwards rather than forwards, has been demonstrated. Endless negotiations have eventually led to minimal compromises, the domination of the strong and the formation of a kind of 'executive board' comprising Germany and France, because of their economic weight, to the detriment of the other members of the eurozone, as well as a kind of hegemony which is the antithesis of one of the principles of federalism, all accompanied by a reversal of democracy in the EU. Indeed, the intergovernmental method is a step

back to the days when decision-makers ignored the European Parliament. Unlike the Commission, which is alone accountable to the European Parliament, the European Council and the Council do not answer to it. With the Commission's role marginalised, the institutional balance is skewed in favour of government institutions, with the inherent risk that the general European interest will be neglected under the pressure of domestic policy and democratic control will be avoided.

Fortunately, every time that rules need to be drawn up and enforced, a return to the Community method is inevitable. Once pushed aside, the Commission is now making a strong comeback to ensure balance between the large and the not so large Member States and to take into account the various national interests. Since Mr Barroso's speech on the state of the Union and certain new initiatives, the Commission has been throwing itself once again into the role of leader, once wrested from it by Germany and France. We know the result.

Can Europe struggle out of the crisis? There is no magic bullet. Hope and confidence can re-emerge only as part of a European 'New Deal'. The progress made so far, which has been insufficient, must be backed up intensively by three measures needed without delay: the use of eurobonds, stepping up the crucial role of the ECB alongside the Commission and the adoption of an institutional framework for the eurozone.

Proposed by Jacques Delors and Tommaso Padoa-Schioppa, the idea of eurobonds is becoming increasingly popular with governments, economic actors and public opinion. The German government and the ruling coalition partners are divided, whilst exporters are making their voices heard. The President of the Federation of German Wholesale, Foreign Trade and Services (BGA), Anton Börner, takes the view that 'we need eurobonds with a German stamp. We have to take tough measures in the eurozone: a constitutional curb to ban excessive deficits, a modernised administration, greater labour market flexibility, massive investment in training. And we mustn't shy away from the possibility of raising taxes. Any solution apart from eurobonds would cost us more in the long run.' In turn, Finance Minister Wolfgang Schäuble, a veteran Europhile, is

against the adoption of eurobonds as long as member countries continue to run their own budget policy. Economic governance and a European coordination of national budgets, in other words a form of budgetary federalism, supplemented by the close coordination of fiscal policies, the first step towards fiscal federalism. Once these requirements are met, eurobonds would be feasible.

The Commission has proposed 'stability bonds' which would facilitate borrowing at lower interest rates. A breakthrough which should be accompanied by the issue of eurobonds to fund European infrastructure, research, education and innovation projects or job-creating industrial programmes.

One proposal from France was to extend the role of the ECB to make it more like the Fed or the Bank of England, to make it the lender of last resort, providing resources to the European Stability Mechanism. The German veto was not slow in coming, the fear of inflation being ever present. The system would be based on effective governance by the Commission, acting within general guidelines set out by the Council of Heads of State and Government of the eurozone. The leadership council will be chaired by Herman Van Rompuy who, in line with the institutional logic, is President of the European Council. For reasons of balance, a European finance minister, vice-president of the Commission, would be called to chair or co-chair the Council of Finance Ministers of the eurozone. Progress in the creation of institutional structures could be achieved in the context of 'enhanced cooperation'. These are some measures to help to consolidate the eurozone whilst integrating it seamlessly with the single market and the European Union. Time is pressing, as the markets respond quickly and the crisis deepens and spreads. A global challenge warrants a prompt, comprehensive reply. The future of the European Union and, to a great extent, the future of the world economy, depend on the survival of the euro. This is a warning to the markets and an urgent appeal to the European institutions, the governments of the Member States and European citizens.

Annex

Programme of the Global Jean Monnet Conference

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European economic governance in an international context

European Commission, Directorate-General for Education and Culture,
Jean Monnet programme
Charlemagne building — Alcide de Gasperi room
Brussels, 24 to 25 November 2011

Thursday, 24 November 2011

08:15	Registration of the participants
09:15–10:15	Opening session
<i>Moderator</i>	Mr Jan Trzuszczynski, Director-General for Education, Training, Culture and Youth at the European Commission
<i>Opening speeches</i>	Mr José Manuel Barroso, President of the European Commission
	Ms Androulla Vassiliou, Commissioner for Education, Culture, Multilingualism, Sport, Media and Youth
	Ms Anni Podimata, European Parliament
10:15–10:30	Coffee break
10:30–11:00	Scene setter — Keynote speech
	Mr Robert Mundell, Nobel Prize Economics; University Professor of Economics at Columbia University; father of the theory of optimum currency areas
Session 1:	Safeguarding the stability of the euro area and the enhanced instruments for crisis intervention
11:00–13:00	
<i>Chairperson</i>	Mr Edward Scicluna, Member of the European Parliament and Vice-Chair of its Committee on Economic and Monetary Affairs; Professor

of Economics at the University of Malta; former Director of the Central Bank of Malta; former Chairman of the Maltese Financial Services Authority

Lead interventions Mr Roberto Gualtieri, Member of the European Parliament and its Committee on Constitutional Affairs; Rapporteur on the setting-up of a permanent stability mechanism for the euro countries

Mr Nikolaos Baltas, Jean Monnet Chair at the Athens University of Economics and Business

Mr Daniel Gros, Director of the Centre for European Policy Studies

Mr Guntram Wolf, Deputy Director of Bruegel

Session editor Mr Eric Le Boucher, Director of Enjeux-Les Echos, Paris; former Editorialist of Le Monde

12:30–13:00 Debate

13:00–14:30 Standing lunch

Session 2: **Reinforced fiscal and macroeconomic coordination and surveillance: economic aspects**

14:30–16:00

Chairperson Mr Josep Borrell, former President of the European Parliament; President of the European University Institute; former Spanish Minister for Public Works, Transport, Environment, Housing and Telecommunications and former Spanish State Secretary for Finance

Lead interventions Ms Elisa Ferreira, Member of the European Parliament and its Committee on Economic and Monetary Affairs; Rapporteur on the prevention and correction of macroeconomic imbalances; Lecturer of Economics at the University of Porto

Ms Laurence Boone, European economist at the Bank of America Merrill Lynch; former chief economist at Barclays Capital; former economist at the OECD

Mr Sylvester Eijffinger, Jean Monnet Chair of European Financial and Monetary Integration at the Centre for Economic Research at Tilburg university; President of the Tilburg University Society; Member of the Panel of Economic and Monetary Experts of the European Parliament's Committee on Economic and Monetary Affairs

Mr Paul J. J. Welfens, Jean Monnet Chair at the Institute of Macroeconomic Theory and Politics of the University of Wuppertal; President of European Institute for International Economic Relations

Session editor Mr Detlef Fechtner, EU Correspondent of Börsen-Zeitung

15:30–16:00 Debate

16:00–16:15 Coffee break

Session 3: **Strengthening the governance of the European area: political and institutional aspects**

16:15–18:00

Chairperson Mr José-Maria Gil-Robles, former President of the European Parliament; President of the European University Council for the Jean Monnet programme; Jean Monnet Chair and Director of the Jean Monnet Centre of Excellence at the Complutense University of Madrid; President of the Jean Monnet Foundation

Lead interventions Mr Nikolaos Chountis, Member of the European Parliament and its Committee on Economic and Monetary Affairs

Ms Amy Verdun, Jean Monnet Chair, Director of the Jean Monnet Centre of Excellence and Chair of the Political Science Department at the University of Victoria

Mr José María de Areilza, Jean Monnet Chair and Dean of the IE University Law School

Session editor Mr Pierre Lemoine, executive publisher and editor-in-chief of *Europolitcs*

- 17:30–18:00 Debate
- 19:30–22:00 Conference dinner at Husa President Park, Boulevard du Roi Albert II, 44-1000 Brussels

Friday, 25 November 2011

Session 4: The EU and global macroeconomic governance (G8, G20, IMF)

09:00–11:00

Chairperson Mr Enrique Barón Crespo, former President of the European Parliament; Jean Monnet Chair at the Universidad de Castilla La Mancha; former Spanish Minister for Transport, Tourism and Communications

Lead interventions Mr Marco Buti, Director-General for Economic and Financial Affairs at the European Commission

Ms Olga Butorina, Jean Monnet Chair in Economics and Head of the European Integration Department at the Moscow State Institute of International Relations in Russia

Mr Dai Bingran, Jean Monnet Chair and Honorary Director of the Jean Monnet Centre for European Studies at Fudan University; Secretary General of the Chinese Society for EU Studies

Mr Woosik Moon, Jean Monnet Chair in Economics at the Graduate School of International Studies of Seoul National University, Korea

Session editor Mr Stanley Pignal, Brussels correspondent of the Financial Times

10:30–11:00 Debate

11:00–11:15 Coffee break

11:15–12:45 **Closing session**

Moderator Mr Jan Trzuszczynski, Director-General for Education, Training, Culture and Youth at the European Commission

Closing speakers

Mr Fritz Breuss, Professor at WU Vienna

Viscount Etienne Davignon, Belgian Minister of State; former Vice-President of the European Commission; former President of the International Energy Agency; former President of the Société Générale de Belgique; Chairman of Brussels Airlines, the Compagnie Maritime Belge, CRS Europe

12:45–14:00

Standing lunch

