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Towards a New EMU

Fritz Breuss

447/2013

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WIFO Working Papers, No. 447

March 2013

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The global financial and economic crisis in 2008-09 followed by a "Euro crisis" – not a crisis of the Euro but a sovereign debt (and/or banking) crisis in some Euro countries – forced to reforms of the asymmetric policy design of the Economic and Monetary Union (EMU). Starting with ad-hoc rescue operations for Greece, Ireland and Portugal a whole bunch of reform steps were necessary to make the Euro area "crisis-proof" for the future. Whether the measures taken are already enough to make the EMU better functioning in future crises is an open question. Nevertheless, the crisis proved to act like Schumpeter's "process of creative destruction": the old (not crisis-proof) institutional set-up has been gradually changed towards a more centralised fiscal policy at EU/Euro area level within a new EMU economic governance. Besides the improvement of the policy instruments of the "Economic Union" of EMU, also the ECB with its monetary policy entered more and more into the role of a lender of last resort of the banking sector. More far-reaching plans (that of Barroso and of Van Rompuy) are already on the table which should transform the European Union from a "Fiscal and Transfer Union" over a "Banking Union" into a genuine EMU with the final goal of a "Political Union", not to mention the "United States of Europe" (USE).

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2013/052/W/0

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Towards a New EMU

Fritz Breuss

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Abstract

The global financial and economic crisis in 2008/09 followed by a “Euro crisis” – not a crisis of the Euro but a sovereign debt (and/or banking) crisis in some Euro area member states – forced to reforms of the asymmetric policy design of the Economic and Monetary Union (EMU). Starting with ad hoc rescue operations for Greece, Ireland and Portugal a whole bunch of reform steps were necessary to make the Euro area “crisis-proof” for the future. Whether the measures taken are already enough to make the EMU better functioning in future crises is an open question. Nevertheless, the crisis proved to act like Schumpeter’s “process of creative” destruction: the old (not crisis-proof) institutional set-up has been gradually changed towards a more centralized fiscal policy at EU/Euro area level within a new EMU economic governance. Besides the improvement of the policy instruments of the “Economic Union” of EMU, also the ECB with its monetary policy entered more and more into the role of a “Lender of last resort” of the banking sector. More far-reaching plans (that of Barroso and of Van Rompuy) are already on the table which should transform the European Union (EU) from a “Fiscal and Transfer Union” over a “Banking Union” into a genuine EMU with the final goal of a “Political Union”, not to mention the “United States of Europe” (USE).

Keywords: Economic and Monetary Union, Eurozone, European Integration, EU.

JEL Classification: E42, E61, F15, F33, F41, F53

This study is part of a project (“*Possible Futures of the Eurozone*”) funded by the “Jubiläumsfonds der Oesterreichischen Nationalbank“ (Project No. 14261).

Contents

1. Introduction	1
2. Current institutional set-up of EMU	2
2.1 Institutional interplay of EMU à la Lisbon Treaty	3
2.2 EMU's asymmetric policy design failed in the crisis	4
Box I: The Benefits of the Euro	7
3. The New EMU economic governance.....	9
3.1 New EMU economic governance – a gateway to an Economic Union	9
Box II: Limited Fiscal Union à la Bruegel	18
3.2 More “Europes” after the crisis instead of “more Europe”?	32
4. What kind of “EMU” in a Future EU?	34
4.1 The „Barroso“ Plan for a deep and genuine EMU	35
4.2 The „Van Rompuy“ Plan for a genuine EMU	46
4.3 The new role for the ECB – Lender of Last Resort?	50
5. Four Scenarios for the Future of the Euro	56
5.1 Scenario 1: Monetary bridging – status quo.....	57
5.2 Scenario 2: Fiscal pact plus	58
5.3 Scenario 3: Closer Fiscal Union and “Fiscal Transfer Union”	58
5.4 Scenario 4: Northern euro/euro break-ups.....	59
Box III: From “Grexit” to “Brexit”?	60
6. Conclusions	61
7. References.....	63

1. INTRODUCTION

The 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 Euro zone. With the accession of Croatia in July 2013, we have EU-28. 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 devaluating against the Euro. Due to the unfolding debt problems in some member states of the Euro zone in the aftermath of the global financial and economic crisis (GFC) as of 2008/09 one can hardly expect a fast expansion of the Euro zone. On the contrary, one could rather expect a downsizing of the Euro zone if the problems of indebtedness and the absence of competitiveness in the periphery countries cannot be solved quickly. Nevertheless, Lithuania is preparing for the introduction of the Euro in 2014.

A breakdown of the Euro zone 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 marginalize Europe and the EU in the international political and economic power play (globalisation). 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 relentlessly by the crisis 2009. More Europe is needed – not only in the monetary policy, but also in the area of economic and fiscal policy (fiscal union) and in the financial sphere (banking 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 Euro zone as „Euro crisis“ one should not forget that we do not have a „crisis of the Euro“. An obvious indication 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 has fluctuated within a band of 1.20 to 1.50 USD/EUR.

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, national 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. Symptomatic for EU's EMU is the famous undertaking and failure of the

„*Union monétaire latine*“ (see Theurl, 1992).

The European Union is - according to the judgement of the German Federal Constitutional Court (Bundesverfassungsgericht, 1993) - only a „Union of States“ (Staatenverbund) because Europe misses an own statehood and citizenship. As a consequence the Euro zone with its 17 member states work on the basis of an asymmetric economic policy architecture. In contrast, US's economic policy acts symmetrically. In EMU the centralized monetary policy goes along with a decentralized 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 realized in 1998 in the Maastricht Treaty because of the British veto) and lastly the „United States of Europe,, (USE). First steps into this direction are done by the creation of a New Economic Governance in the EU/Euro area, based on the building blocks: “Fiscal Union” (inclusive a “Transfer Union”) and a “Banking Union”, leading the EMU in the long awaited “Economic Union”.

In the following we start with a description of the current institutional set up à la Lisbon Treaty and its flaws in the crisis. This is followed by a presentation of the new reform steps at EU and Euro area level (the New Economic Governance) which have already been implemented since the outbreak of the Euro crisis in 2010. Finally, realistic and utopian futures of EMU are discussed, based on proposals by independent think tanks or EU officials, like those in the “Barroso” and the “Van Rompuy” plans. The latter are still in a status of brainstorming. The possible economic impact of the EMU reform steps are then demonstrated with four scenarios of possible futures of the Euro area.

2. CURRENT INSTITUTIONAL SET-UP OF EMU

The institutional set-up of EMU and its legal basis did not change very much since the Maastricht Treaty which came into force on 1 October 1993. Only minor corrections concerning the EMU were made in the Lisbon Treaty which came into force on 1 December 2009. The “Euro” is explicitly mentioned in Art. 3(4) TEU¹ as the single currency of the Union and also the formerly informal “Euro Group” is now (in Art. 137 TFEU² and in Protocol No. 14) legally founded in the Treaty. The Euro crisis, however, made major regulations of economic governance of EMU already obsolete.

¹ Treaty on European Union.

² Treaty on the Functioning of the European Union.

Group and the ECOFIN is done in the Economic and Financial Committee (EFC; Art. 134 TFEU). There is no “full cooperation” between the ECB and the ECOFIN – only a “dialogue” - and hence EMU cannot profit of the maximum potential of coordination which several studies postulated (see Breuss, 2006, pp. 543 ff.).

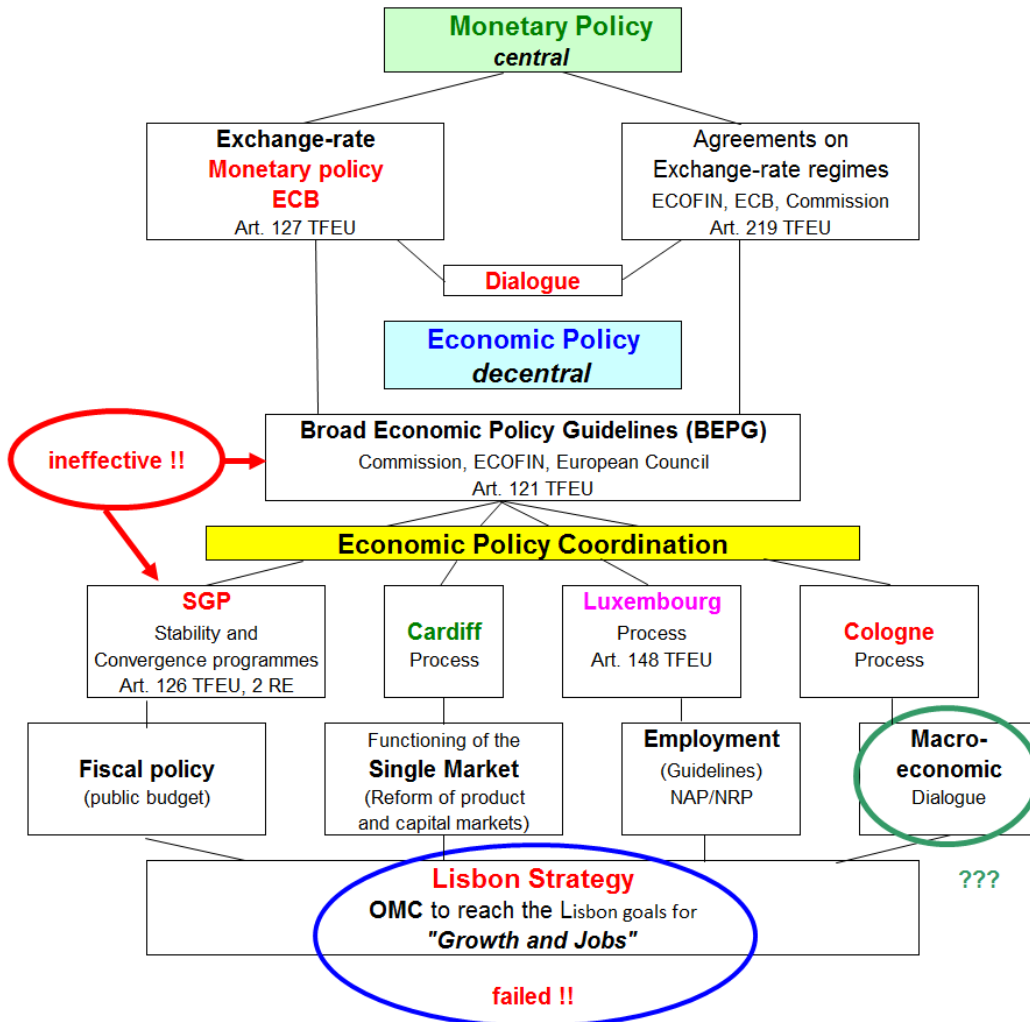
2.2 EMU’s asymmetric policy design failed in the crisis

The interplay of a centralized monetary policy by the ECB and a decentralized economic (fiscal policy) by the EU member states, coordinated by numerous procedures and processes was only the “simulation” of a functioning EMU comparable to that of the USA with a centralized monetary and fiscal policy. This artificial “asymmetric design” of EMU’s economic policy making is founded on the absence of a statehood of the European Union and the illusion that a monetary union can properly function on the principle of “one market, one money” instead of the sound and approved principle “one country, one money”. In the “fair weather period” this artificial policy construction worked quite well, but it failed in the crisis since 2009/2010.

The structure of the “asymmetric policy design” of EMU which worked pretty well until the GFC of 2009 is summarized in Figure 2. A major pillar of economic policy coordination, the Stability and Growth Pact (SGP) did not work properly to avoid the accumulation of public debt after the GFC of 2008/09. Not only in the recent Euro crisis the SGP was ineffective (not binding) but it suffered the loss of credibility also in the past when France and Germany between 2002 and 2004 breached the rules of the SGP. What followed where a revision of the SGP-II (see Breuss, 2007). Also the “macro-economic dialogue” within the Cologne process did not help very much. A similar – largely only - bureaucratic instrument of coordination were the Broad Economic Policy Guidelines of the Member States of the Union (BEPG), regulated in Art. 121 TFEU. The BEPG is annually produced by the European Commission and rubber-stamped by the European Council. In the end also the endeavour of the Heads of State or Governments, to coordinate economic policy intergovernmental via the Open Method of Coordination (OMC) was ineffective. OMC was one of the instruments in connection with the failed Lisbon Strategy intended to push Europe to one of the leading growing regions in the world in the coming decade starting in 2000 (see European Council, 2000³, p. 2).

³ “The Union has today set itself a *new strategic goal* for the next decade: *to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion*”.

Figure 2: Asymmetric Policy Design of EMU until the crisis 2009
Economic Policy Coordination and Dialogue with the ECB



NAP = National Action Plans; NRP = National Reform Plans; OMC = Open Method of Coordination
Source: Breuss (2011B, p. 3)

Since 2009/2010 EU's EMU has undergone its most severe crisis. As Commission's president Barroso (2012) put it in his "State of the Union 2012 Address" in a nutshell, at its roots, the Euro crisis is the result of three (partly overlapping and reinforcing) causes:

- Irresponsible practises in the financial sector, triggering off a "Banking Crisis"

- Unsustainable public debt, resulting in a “*Sovereign Debt Crisis*”, and also;
- A lack of competitiveness in some Member States, causing “*Macroeconomic Imbalances*” and a “*Balance of Payments (BoP) Crisis*”.

A reform of the policy design of EMU must start to address these topics.

The three causes of the Euro crisis can be characterized as follows:

- *Banking Crisis*: It started in the United States with the subprime crisis in 2007/08. The burst of the US housing bubble in connection with the financial “innovation” and world-wide sale of Collateralised Debt Obligations (CDOs) based on US mortgage-backed securities (MBS) lead to a banking crisis in the USA, culminating in the Lehman Brothers collapse on 15 September 2008. This US subprime plus banking crisis spilled over to other countries and caused a global economic crisis in 2009, called by Paul Krugman (2009) the “Great Recession” (see also Breuss, 2011A). The burst of the housing bubble in Ireland and Spain ignited a banking crisis, combined with a sovereign debt crisis in these countries.
- *Sovereign Debt Crisis*: Indebtedness of some Euro area member states, in particular in the PIIGS⁴ in the periphery of the Eurozone. This is part of the construction flaw of the Euro zone and most recently the result of the GFC 2008/09. The GFC amplified the debt problems in the already competitively weak periphery countries of the Euro area. Their debt to GDP ratios exploded over the “magic” level of 90% of GDP which, according to Reinhart-Rogoff (2009, 2010, and 2011) are unsustainable levels which can lead to a contraction of real GDP growth by one percentage point p.a. over a long period of budget consolidation.
- *BoP Crisis (Macroeconomic imbalances)*: The drifting apart of *competitiveness* (measured by ULC – unit labour costs - relative to Euro area average) of the Euro area countries is the practical proof of the conjecture at the start of EMU that only a small EMU would fulfil the criteria of an Optimum Currency Area (OCA; see Breuss, 2006, p. 386 ff., 2011C and Handler, 2013). These imbalances already existed at the inception of EMU in 1999. 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)⁵.

⁴ Portugal, Ireland, Italy, Greece and Spain.

⁵ For an empirical study on the interconnection of fiscal divergence and current account imbalances in Europe, which became stronger since the start of EMU in 1999, see Schabl and Wollmershäuser (2013).

Box I: The Benefits of the Euro

The idea behind the introduction of the Euro is to utilize the remaining potentials of the Single Market, comparable to the situation in the United States. Unfortunately, EU's Single Market is larger (27 member states) than that of the Euro area (17 member states). Nevertheless, the Euro since its inception in 1999 already generated considerable benefits, although the Euro integration effects differ from country to country. According to the study by McKinsey (2012, pp. 8-11) the membership of the Euro brought an overall benefit of €332 billion cumulated in 2010, or 3.6 percent of Eurozone GDP over a ten years period; the benefits, however, were distributed unequally among countries.

All Eurozone countries felt a positive impact of the introduction of the Euro but to very different extents and based on different levers (see Table 1). The clear winners included Austria, Finland, Germany and the Netherlands. In absolute terms Germany received half of the total benefits, in relative terms Austria was the winner with 7.8% of GDP cumulated over a ten years period or 0.8 percentage points per annum (compared to an annual GDP effect of 0.4% according to estimates by Breuss, 2010, p. 129; 2012A, p. 43; 2013).

Table 1: Benefits from the Euro

Benefit from the €		
GDP growth due to EMU participation, cumulated 1999-2010		
Country	GDP increase in bn €	in % of GDP
Austria	22	7,8
Finland	12	6,7
Germany	165	6,4
Netherlands	37	6,2
Italy	44	2,7
Portugal	4	2,1
Spain	8	0,7
France	14	0,7
Greece	0,172	0,1
Other 8 €-MS	27	
Euro zone total	332	3,6

Sources: McKinsey (2012, p. 9) and quoted in Welt-Online, 10 January 2012

McKinsey (2012, p. 9) arrives to the overall integration effects of €332 billion by analysing four levers or determinants of integration effects of the Euro:

- 1) Technical lever: The integration effects are here derived from the reduction of transaction and hedging costs that effectively operate like a tax on trade, reducing the profitability of exports and imports and also the flows of tourists. Eurozone countries have benefited, in aggregate by about 0.4 percent of GDP – around €37 billion.
- 2) Trade: Currency unions should stimulate trade when the remaining trade barriers (transaction costs) vanish. Initial estimates of the boost to intra-EMU trade were very high. McKinsey (2012) concurs with recent evidence pointing to a 15 percent increase in intra-EMU trade. This accounts for half of the overall increase in intra-EMU trade volume of €600 billion since 1999. The rest came from the further development of the EU's Single Market, more intense globalisation, and strong growth in the wake of the EU's enlargement to Eastern Europe. The Euro stimulated specialisation and hence generated efficiency gains. In total, gains from additional trade contributed about €100 billion in additional GDP or 1.1 percent of GDP.
- 3) Competitiveness: Overall the increase in competitiveness in Northern Europe via redesigning their value chains and reducing ULC and structural reforms of the labour market (in particular in Germany by the Agenda 2010) compensate the loss of competitiveness in Southern Europe. Overall therefore, the competitiveness effect in the Eurozone is zero. In Germany the biggest influence of the overall benefits from the Euro (€165 billion) stems from increased competitiveness (€110 billion or 4.6% of GDP), whereas the trade effect was only €30 billion or 1.2% of GDP. In the periphery countries of the Eurozone, in particular in Italy the competitiveness effect was negative (-€31 billion or -2%) in relation to the overall benefit of €44 or 2.7% of GDP.
- 4) Interest rate: When entering the Eurozone the GIIPS had to lower their interest rates considerably. Pre-euro, Greece's ten-year bonds had yields of up to 25 percent, while German government bond yields were nearer to 8 percent. The pre-euro spreads reflected exchange rate risks, expected divergences in inflation rates, and different creditworthiness. From 2001 onwards, the spreads between government bonds shrank virtually to zero. Eurozone sovereigns' liabilities were treated as almost perfect substitutes. The No-bailout clause, Article 125 of TFEU was judged as not enforceable given the drastic consequences of a sovereign default on financial institutions. After the GFC 2008/09 the increasing spreads reflected default risks. In total, the relative interest rate advantage delivered around €195 billion in additional GDP or 2.1% of GDP in the Eurozone as a whole. The interest rate effect is large in the GIIPS, e.g. in Italy it amounted to €68 billion or 4.4% of GDP and, hence, was the biggest single integration effect of the four levers calculated by McKinsey (2012) due to the introduction of the Euro. In Germany this effect was negligible.

3. THE NEW EMU ECONOMIC GOVERNANCE

In the wake of the Euro crisis, starting with the Greek debt crisis early in 2010 ideas emerged to redesign the economic governance of EMU. All these efforts targeted on more centralization of economic/fiscal policy at EU level and – via stricter rules of ex ante control – avoid statistical cheating with budgetary data like in the case of Greece which twice faked the budgetary reality (the first time shortly after the entry into EMU in 2001 and secondly in the occasion of government change end of 2009).

Already in 1997 in the run-up to EMU France pushed for the installation of an “economic government” (“gouvernement économique”) as a counter balance to the independent ECB. Germany opposed this idea and – as a compromise – advocated the informal “Euro Group” which finally was made legal in the Lisbon Treaty. Additionally to the rules of the Maastricht Treaty (convergence criteria) – based on Theo Waigel’s (the then German finance minister) wish – the Stability and Growth Pact (SGP) as the primary instrument of fiscal coordination was installed to secure fiscal discipline.

3.1 New EMU economic governance – a gateway to an Economic Union

The EMU is based – theoretically – on two pillars: i) an Economic Union (E) and ii) a Monetary Union (M). Until recently the EMU worked practically only with a functioning Monetary Union (the Euro area) based on a centralized monetary policy. The basic pillar of the Economic Union is the Single Market, accompanied by a growth-enhancing strategy (Lisbon and Europe 2020 agenda). Since the creation of the Euro area with its single currency “Euro”, the governance on the side of fiscal policy (as counterpart of monetary policy) was lacking centralization (or unionisation) and was therefore biased towards an asymmetric policy design. It worked quite well during the good weather period until the GFC 2008/09 but turned out to be flawed during the shock of the Euro crisis.

Under the pressure of the Euro crisis many of the flaws of the EMU policy design were corrected. With all the measures already taken to reform the EMU economic governance the EU and the Euro area are on a good way towards a more symmetric policy design for the EMU. More and more the EMU is materializing the missing part of EMU, the “Economic Union”.

After a long debate and confusion about the correct name (“economic governance or government”) of the new policy arrangement in EMU (see Breuss, 2011B; Gloggnitzer-Lindner, 2011; Essl, 2012) the Heads of State or Government decided on the March 2011 summit to call the new policy method “economic governance”. A “real” “economic government” would imply a

Political Union with a hierarchical tree of decision-making like in the United States – a situation which lies far in the future in Europe (see Heise and Gömöz-Heise, 2010; Jamet, 2010 and Breuss, 2011B, p. 3).

The other – still open question – is which institution should take over the part of an “EU economic government”, the European Commission (which its representatives and its president José Manuel Barroso insist on) or the Heads of State of Government (i.e. the European Council) which was strongly supported by the two major players Merkel and Sarkozy (“Merkozy”), followed by “Merkholland”.

Because of the current indecisiveness in this question and also because of the different speed of the emergence of the problems (the financial markets react fast and create uncertainties) and solving strategies (the member states of the EU and the Eurozone and also the EU institutions work slowly due to the consideration of their democratic procedures – parliamentary votes etc.) the Commission has corded already a comprehensive package of measures at different levels which partly, already entered into force.

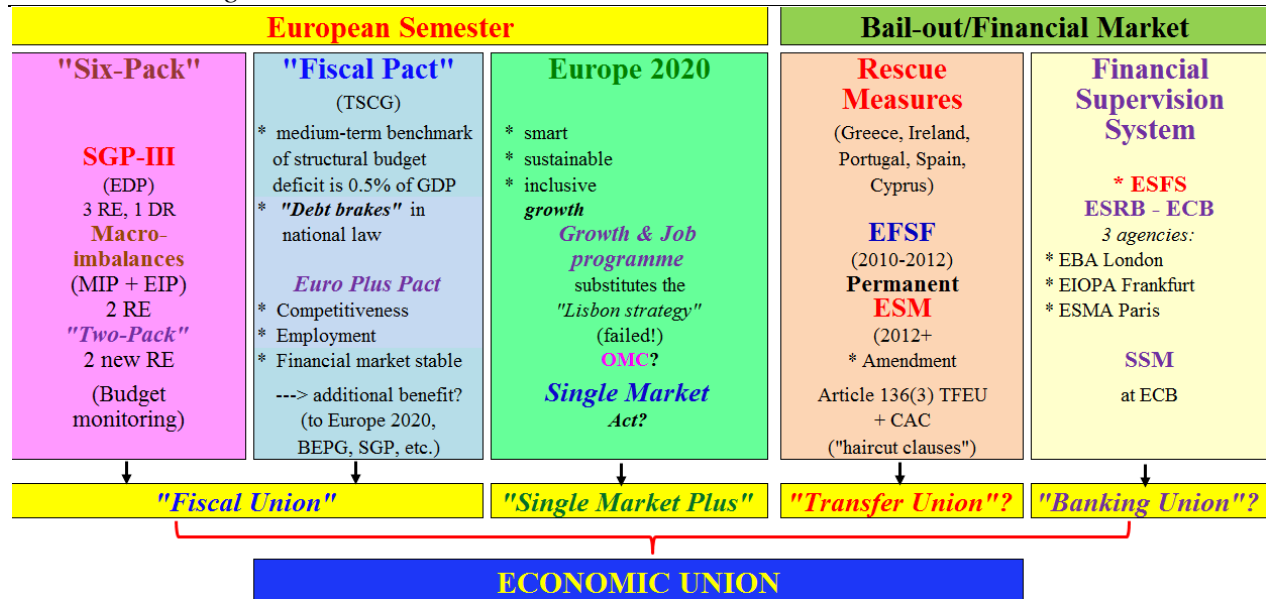
On the one hand they are based on EU law (Treaty-related) according to the so-called Community Method (CM) – like the “Six-Pack” and financial market surveillance - and on the other hand they work intergovernmental (IG) at the level of representatives of EU and Euro zone member states by the Heads of State or Government (like the Fiscal Pact and the rescue instruments EFSF/ESM). The latter actions are executed for the time being outside the EU Treaty.

The New Economic Governance of EMU consists of the following components or pillars (see Figure 3):

- The *first pillar* is “Economic Governance” managed under the headline “European Semester”, already in place since 2011 and constitutes the beginning of a “Fiscal Union” (with “Six-Pack”, “Two-Pack” and “Fiscal Pact”) and of an “Economic Union” (with the 20 year old – but still not completed – “Single Market” and the growth strategy “Europe 2020”)
- The *second pillar* consist of the rescue (or Bail-out) instruments EFSF and ESM, leading the Euro area into a “Transfer Union”
- The *third pillar* concerns the re-regulation and surveillance of the financial market and consists of the already (since 2011) existing Financial Supervision System (ESFS) and will be complemented by a European “Banking Union” in the future.

All together they are building blocks as a gateway towards an “Economic Union”.

Figure 3: New Governance of EMU Economic Policy (“EU Economic Government”), leading to an Economic Union



BEPG = Broad Economic Policy Guidelines; CM = Community method; IG = Intergovernmental method; SGP = Stability and Growth Pact; EDP = excessive deficit procedure; RE = regulation; DR = directive; MIP = Macroeconomic Imbalances Procedure; EIP = Excessive Imbalance Procedure; OMC = Open method of coordination; EFSF = European Financial Stability Facility; ESM = European Stability Mechanism; CAC = Collective Action Clauses; ESFS = European System of Financial Supervisors; ESRB = European Systemic Risk Board; EBA = European Banking Authority; EIOP = European Insurance and Occupational Pension Authority; ESMA = European Securities and Markets Authority; SSM = Single Supervisory Mechanism; TSCG = Treaty on Stability, Coordination and Governance in the EMU (“Fiscal Pact”).

Sourc: Breuss (2011B), p.8 and updates.

A) European Semester (ES)

The ES was approved by the EU member states (ECOFIN Council decision) on 7 September 2010 based on a proposal by the European Commission made in May and June 2010 (more information on the ES, see European Commission, 2011A⁶). The ES started with a first round in 2011. In the first half of every year a cycle of intensive coordination takes place between EU institutions and 27 EU member states. The ES starts with the Annual Growth Survey (AGS; see

⁶ All information about the new “EU economic governance”, legal acts of the “Six-Pack”, “European Semester” etc can be found on the website of the European Commission, DG Economic and Financial Affairs: http://ec.europa.eu/economy_finance/economic_governance/index_en.htm

AGS, 2012⁷). The AGS, along with a review of draft National Reform Programmes (NRP) and the Stability and Convergence Programmes (SCPs) by the EU member states are the first steps of the ES, which involves simultaneous monitoring of the member states' budgetary policies and structural reforms, in accordance with common rules, during a six-month period every year (see Breuss, 2011B). This ex ante control of the budgets of the EU member states has the advantage of avoiding cheating (like in the case of Greece) but derogates some of the essential "kings rights" of the national parliaments, namely to decide exclusively on the national budget.

The ES is, hence, the coordination "bracket" of economic governance over several categories of economic policies. It is interlinked with the macro policy surveillance under the "Six-Pack", the micro and structural policy oriented agenda of the "Euro Plus Pact", the new "Fiscal Pact" and the growth strategy "Europe 2020", following the failed Lisbon strategy.

i) Components of a "Fiscal Union"

With the legal package of the "Six-Pack" and "Two-Pack" and with the "Fiscal Pact", the EMU already has implemented important building blocks of a "Fiscal Union". What is still missing is a "European or Euro-area finance minister", proposed by Jean Claude Trichet (2011A, 2011B) or at least a "Fiscal capacity" as suggested in the "Barroso" and "Van Rompuy" plans (see more in the chapters 4.1 and 4.2). Alternative designs of a European Fiscal Union are discussed by the Bruegel model (see Box: Limited Fiscal Union à la Bruegel) or in the special issue of CESifo Forum (2012A).

Six-Pack

It would be important to have a stronger centralized fiscal policy at EU level as pendant of the already centralized monetary policy. Up to now the "centralized 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 or circumvented twice by data manipulations in Greece; in addition its violation was never sanctioned. Hence, hitherto the SGP was not binding and therefore inefficient.

(a) *SGP-III*: On 13 December 2011 the „*Six-Pack*“⁸ with five regulations and one directive was put into power. Three regulations and one directive target at reforming the SGP (SGP-III; after

⁷ Details on the AGS can be found on the website of José Manuel Barroso, president of the European Commission: http://ec.europa.eu/commission_2010-2014/president/news/documents/2011/11/20111123_documents_1_en.htm

⁸ All legal documents of the „*Six-Pack*“ can be found on the website of on the website of the European Commission, DG Economic and Financial Affairs: http://ec.europa.eu/economy_finance/economic_governance/index_en.htm.

A short guide to the new EU fiscal governance can be found on the Commission website: http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm

the first reform in 2005, SGP-II; see Breuss, 2007), two regulations deal with the surveillance of macroeconomic imbalances.

Novelties in the SGP-III (see Breuss, 2011B; Holler-Reiss, 2011):

- “*European Semester*” is integral part of a closer coordination of economic policy and multilateral surveillance.
- “*Economic Dialogue*”: European Parliament with Council and Commission.
- *Benchmark* for medium-term of cyclically-adjusted (*structural*) *budget balance* (SB) is 0.5% of GDP. For member states facing a debt level beyond 60% of GDP, the SB must be improved annually by 0.5% of GDP: For member states that have not reached its medium term-term budgetary objectives (MTO) public expenditures should grow less than the rate of potential GDP, for those which have reached their MTO public expenditure can rise with the rate of potential GDP (this is an “implicit debt brake”).
- Monitoring *debt dynamic*: The public debt to GDP ratio (PD) is sufficiently diminishing and approaching the benchmark (reference value of 60% of GDP) if the differential with respect to 60% has decreased over the previous three years at an average rate of one twentieth per year (1/20 rule of debt reduction)⁹.
- *Sanctions*: i) in the preventive part of the SGP: interest-bearing deposit of 0.2% of GDP of the previous year; ii) in the corrective part of the SGP: in case of non-compliance a) a non interest-bearing deposit of 0.2% of GDP of the previous year; if no corrections have been made b) a fine of 0.2% of GDP of the previous year. The deposits and fines will be assigned to the EFSF.
- *Reversed qualified majority voting* (RQMV) in case of sanctions: A decision by the Commission shall be deemed to be adopted by the Council unless it decides by a qualified majority to reject the Commission’s recommendation within 10 days. This “quasi-automatic” voting procedure strengthens the position of the Commission.
- *Sanctions* concerning the manipulation (intentionally or by serious negligence misrepresentation of *budgetary statistics* (deficit and debt data): This “Lex Greece” is sanctioned by a fine of 0.2% of GDP of the previous year. In order to avoid another “Greek case” in the future a new directive will aim at defining the requirements of budgetary frameworks – rules how to make the budgetary statistics.

“Two-Pack”: 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 excessive deficit procedure (EDP)

⁹ The formula to calculate the “1/20 debt reduction benchmark”, used by the European Commission, can be found in the “2011 Report on Public finances in EMU” (European Commission, 2011E, p. 89).

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 EFSF (European Financial Stability Facility), ESM (European Stability Mechanism) and/or IMF. The “Two-Pack” will enter into force in 2013, after the trilogue agreement between representatives from the European Parliament, the Council and the Commission on 20 February 2013.

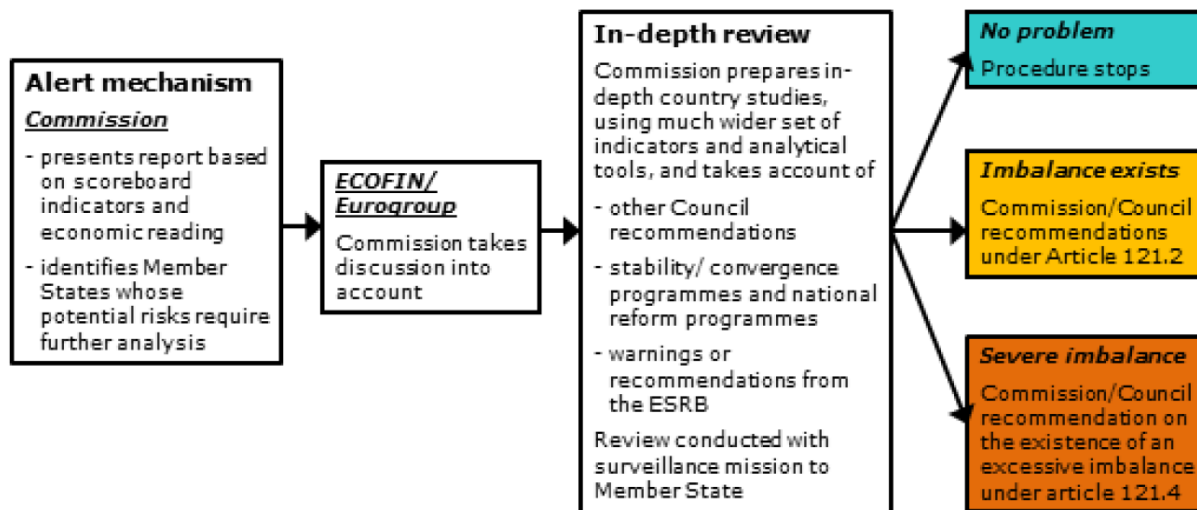
These measures, based on the Lisbon Treaty (rules within the “Community Method”) are welcome as a good step further to improve “Economic Governance”. However, they are still (even though now tightened) a continuation of the hitherto “simulation” of a centralized fiscal policy at EU level.

(b) *MIP and EIP*: 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 Euro zone average) grew steadily larger. The big winners of this competition race (Germany and Austria) within the Euro zone stood face to face with the PIIGS as competition losers. The fact of the drifting apart of competitiveness in the Euro zone (or the non-convergence towards a “European business cycle”) can also be seen as a falsification of the endogenous “Optimum Currency Area” (OCA) theory (see Breuss, 2011C; Handler, 2013). This theory postulated that after the introduction of the Euro the intra-Euro zone 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 Euro zone under the Macroeconomic Imbalance Procedure (MIP) using a Scoreboard with a set of 10 indicators indentifying and monitoring imbalances (e.g. current account, real exchange rates or relative unit labour costs etc.).

After going through the MIP in the end an Excessive Imbalance Procedure (EIP) can be initiated by the European Commission (see Figure 4). The EIP is a copy of the Excessive Deficit Procedure (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 imbalances only current count balances outside the range of -4% and +6% of GDP (see European Commission, 2011C, 2012A, 2012B, 2012C).

Figure 4: Overview of the Macroeconomic Imbalance Procedure (MIP)



Source: European Commission (2012C).

In its 1st Alert Mechanism Report (“AMR”) on the prevention and correction of macro-economic imbalances the European Commission (2012A) analysed the economic performance of all 27 EU member states according to 10 scoreboard indicators (European Commission, 2012A: five deal with external imbalances and competitiveness – like current account balances and export market shares etc. and five concern internal imbalances like house prices, private and public sector debt etc.) with the following verdict:

Based on the economic analysis and the scoreboard for 2010, the European Commission considered that *12 EU Member States* warrant an *in-depth review*. The European Commission considered that the risks of imbalances in the following countries warrant further investigation: *Belgium, Bulgaria, Denmark, Spain, France, Italy, Cyprus, Hungary, Slovenia, Finland, Sweden and the UK*.

Countries subject to the EU's financial assistance programme are not assessed in the Alert Mechanism Report as they are already subject to enhanced economic surveillance. This concerns *Greece, Ireland, Portugal and Romania*.

The Report concluded that the following countries do *not* require a further in-depth review at this point in time: *the Czech Republic, Germany, Estonia, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Austria, Poland, and Slovakia*. However, for these countries, there will be recommendations on fiscal and macroeconomic policies within the scope of the European Semester.

Since the first assessment of macroeconomic imbalances (1st AMR, based on data when the Euro crisis started), one can see a considerable progress concerning the necessary adjustments, in particular in the PIIGS (see, EEAG, 2013). In the course of the Euro crisis they devaluated as required “internally” (lowered their ULC and increased productivity) which reduced the imbalances in the current accounts of the reform (periphery) countries of the Euro area. These adjustment progress has also been acknowledged in the 2nd AMR 2013 (see European Commission, 2012G), based on data of the year 2011.

“Fiscal Pact”

In the statement by the Euro area Heads of State or Government in December 2011 (see Euro area, 2011B; reiterated in January 2012; see Euro area, 2012A) a “new fiscal compact” has been announced which should create a “fiscal stability union” (for short, a “Fiscal Union”). However, at the informal summit on 30 January 2012 (see Euro area, 2012B) the name of the fiscal compact has been changed to a new “*Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*” (see TSCG, 2012). The Treaty (for short in the following called “Fiscal Pact”) aims to strengthen fiscal discipline through the introduction of more automatic sanctions and stricter surveillance, and in particular through the “balanced budget rule”.

Main rules of the fiscal compact

The new Treaty requires national budgets to be in balance or in surplus. This will be achieved if the annual structural government deficit does not exceed 0.5% of nominal GDP. If a member state deviates from this rule, an automatic correction mechanism will be triggered. The mechanism will fully respect the prerogatives of national parliaments.

Furthermore, the member states will have to incorporate this “balanced budget rule” (“debt brake”) into their national legal systems, at constitutional level or equivalent. The deadline for doing so is one year at the latest after the entry into force of the treaty.

“Debt brake” in accordance with SGP-III

There is an obligation for those Contracting Parties whose government debt exceeds the 60 % reference value to reduce it at an average rate of one twentieth per year as a benchmark (1/20 rule).

Progress towards and respect of the medium-term objective shall be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, in line with the provisions of the revised Stability and Growth Pact (SGP-III).

Legal Uncertainties

Should a member state fail to transpose the “balanced budget rule” rule on time, the EU Court of Justice will have jurisdiction to take a decision on the matter. The Court's decision will be binding, and, if not implemented, can be followed up with a penalty of up to 0.1% of GDP. This

amount will be payable to the European Stability Mechanism (ESM) if the country's currency is the euro, otherwise to the general budget of the EU.

The matter of non-compliance with the implementation of the “debt brake” into national law can be brought to the Court of Justice of the EU by one or more of the Contracting Parties!!

Voting according to the RQMV

The excessive deficit procedure will also be more automatic. For it not to be applied to a euro area member state, a qualified majority of euro area member states will have to vote against it (reversed qualified majority voting - RQMV) like in the reformed SGP-III.

Coordination mechanism

The member states parties to the new treaty will report their public debt issuance plans to the European Commission and to the Council. They will coordinate among themselves and with the EU institutions in advance all of the major economic reforms that they plan to undertake.

Governance in the euro area

The euro area member states will hold meetings at least twice a year and will elect the president of the euro area summit by a simple majority of votes. Reports of the meetings will be presented to the European Parliament (EP). The President of the EP may be invited to be heard at the euro summit.

Further steps

The treaty has been signed in March 2012 and came into force once it has been ratified by at least 12 Euro area member states. It is legally binding as an international agreement and will be open to the EU countries which do not sign it at the outset. The TSCG entered into force on 1 January 2013 for the 16 states which completed ratification prior to this date¹⁰.

The aim is to incorporate it into EU law within five years of its entry into force.

Connection with ESM

The granting of assistance in the framework of new programmes under the ESM will be conditional, as of 1 March 2013, on the ratification of this Treaty by the Contracting Party concerned and, as soon as the transposition period mentioned in Article 3(2) has expired, on compliance with the requirements of this Article,

Connection with the Euro Plus Pact

The signatories of the Fiscal compact also adhere to the Euro Plus Pact endorsed by the Heads of State or Government of the euro area Member States and of other Member States of the European Union on 25 March 2011 which identifies the issues that are essential to fostering competitiveness in the euro area.

¹⁰ The German Constitutional Court (Bundesverfassungsgericht, 2012) in its ESM judgement gave “green light” for implementation of the TSCG.

Euro Plus Pact

The Euro Plus Pact (EPP) has been agreed upon by the euro area Heads of State or Government on the March 2011 summit (see European Council, 2011) for stronger economic policy coordination for competitiveness and convergence. The EEP also joined Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. Other member states are invited to participate on a voluntary basis. It is an intergovernmental arrangement and should strengthen the economic pillar of the EMU, achieve a new quality of economic policy coordination, improve competitiveness, thereby leading to a higher degree of convergence.

Each year, concrete national commitments will be undertaken applying best practices and benchmark against the best performers within Europe. There will be no sanctions – the implementation of commitments and progress towards the common policy objectives will be monitored politically by the Heads of State of Government of the euro area and participating countries on a yearly basis, on the basis of a report by the Commission.

Box II: Limited Fiscal Union à la Bruegel

Before the Heads of State or Government of the Euro area agreed upon a new “Fiscal compact” to create a “fiscal stability union” (see Euro area, 2011A, 2011B). Marzinotto-Sapir-Wolff (2011) of the Bruegel Institute proposed a “limited fiscal union”, including the creation of a euro-area finance ministry, with a minister with veto rights over national budgets that could threaten euro-area sustainability. The ministry would also assess the liquidity and solvency of governments facing difficulties, and provide support to illiquid but solvent governments. It would be able to rely on federal tax resources, and would set up and back up a Euro-area deposit insurance corporation (EDIC) with banking supervision and resolution authority (see Figure 5).

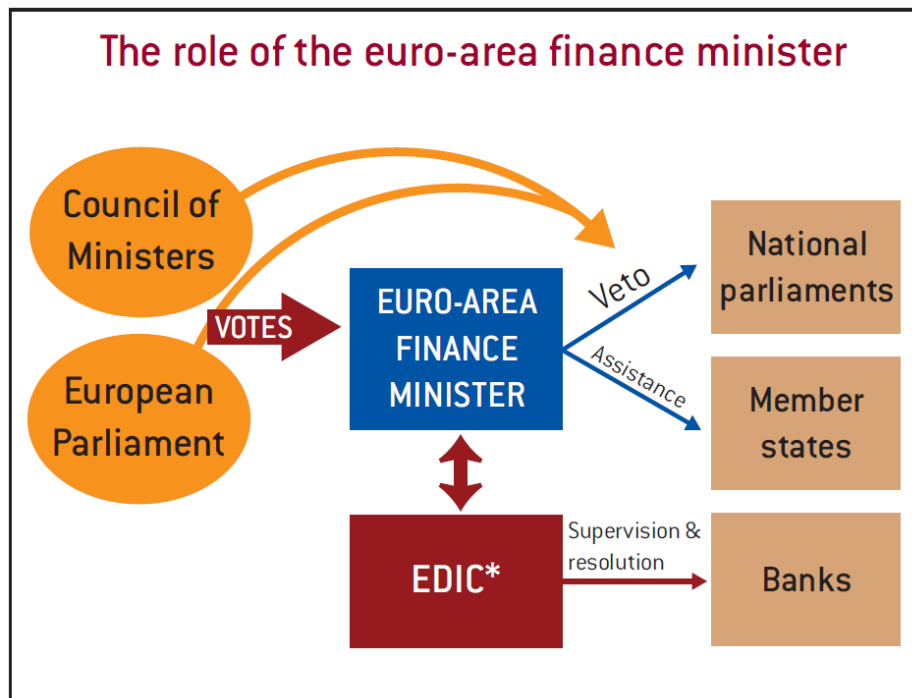
The “Bruegel plan” implies a significant transfer of sovereignty, requiring a new political contract between the Euro area’s nations and people. The finance minister would be held democratically accountable. Setting a clear transition to limited fiscal union should create space for the European Central Bank to act as lender of last resort.

The idea of a “European (or Euro-area) finance minister” goes back to a suggestion by Trichet (2011A, 2011B) in speeches on the occasion of being awarded with the “Karlspreis” in Aachen. In the light of the Euro crisis and the weakness of European institutions he wanted more competence (more centralization) at EU level for monitoring national budgets of the EU member states.

Combined with the installation of the “Euro area finance minister” the Bruegel plan foresees also a stronger role of the ECB. With common euro-area fiscal resources available, the ECB could fulfil the lender-of-last-resort function that its current mandate does not permit.

The concept of a “Euro area finance minister” and hence a stronger centralization of national budgets at EU level would also imply a larger EU budget. It need not be so sizeable as in a the case of a real “fiscal union” like in the USA but the Euro-area finance ministry would need a taxing capacity of perhaps two percent of Euro-area GDP in case loans provided to an illiquid country were to turn bad or bank recapitalisation needs were to exceed the funds available in the EDIC insurance.

Figure 5: EU’s limited Fiscal Union à la Bruegel



*) Euro-area deposit insurance corporation.

Source: Marzinotto-Sapir-Wolff (2011), p. 1

Further discussion on the proper definition or design of a “Fiscal Union” can be found in the special issue of CESifo Forum (2012A).

ii) Strengthening the Single Market as the fundament of an “Economic Union”

The “Economic Union” consists of the 20 year old “Single Market” which has been accompanied by an additional growth strategy in 2000, called “Lisbon Agenda” (which failed). It was substituted by the new strategy “Europe 2020”.

20 Years of the European Single Market¹¹

The Single Market, initiated in 1993 is the basis of European Integration and the fundament of the “Economic Union” of the EU. Although, in 2013 the EU celebrates “20 years of the European Single Market” (European Commission, 2012E) it is still not yet completed. The last task was the heavily delayed implementation of the Services Directive around 2010 which should complete the Services Single Market (for an evaluation, see: Monteagudo-Rutkowski-Lorenzani (2012)). In order to push the completion of the Single Market, the European Commission (2012F) has proposed in its Single Market Act II 12 actions, ranging from developing fully integrated networks to fostering mobility of citizens and businesses across borders (a prerequisite of an optimal currency area) to supporting the digital economy across Europe and strengthening social entrepreneurship, cohesion and consumer confidence.

Europe 2020

Europe 2020 (see Europe 2020, 2010¹²) is the EU's growth strategy for the coming decade. It replaces the failed Lisbon Strategy of the former decade (2000-2010) and should give the Single Market programme additional spin for “growth and jobs”. In a changing world, the EU wants to become a smart, sustainable and inclusive economy. These three mutually reinforcing priorities should help the EU and the Member States deliver high levels of employment, productivity and social cohesion. Concretely, the Union has set five ambitious objectives - on employment, innovation, education, social inclusion and climate/energy - to be reached by 2020. Each Member State has adopted its own national targets in each of these areas. Concrete actions at EU and national levels underpin the strategy¹³.

B) Bail-out Measures and the Surveillance of Financial Markets

i) Elements of a “Transfer Union”

With the start of rescuing some periphery countries, beginning with Greece in May 2010, the EU and in particular the Euro area embarked into a kind of a “Transfer Union”¹⁴.

¹¹ For more details consult “The EU Single Market” website: http://ec.europa.eu/internal_market/index_de.htm

¹² See also the “Europe 2020” website: http://ec.europa.eu/europe2020/index_en.htm

¹³ A first assessment of the possible economic impact of the implementation of the goals of “Europe 2020” can be found in Hobza and Mourre (2010). In an accompanying project the modern aspects of economic growth (“Welfare, Wealth and Work for Europe”) are assessed by an international group of researchers (see, WWWforEurope, 2012).

¹⁴ The combination of an Optimum Currency Area (OCA) and a fiscal “Transfer Union” is theoretically demonstrated with the example of the present Euro area, which in the crisis turned out not to be an optimal currency area (see Breuss, 2011C).

Crisis resolution measures

In the wake of the GFC 2008/09 and in particular starting with the Greek crisis at the beginning of 2010 the “Euro crisis” started to evolve. The EU had no crisis instruments at hand to solve the sovereign debt crises in Greece and other PIIGS countries. Circumventing the “No-bail-out clause” of Article 125 TFEU the Heads of States or Government invented (intergovernmental) ad hoc instruments to assist the most indebted countries with high spreads of their government bonds. These rescue measures were done in cooperation with the IMF which had already such stand-by instruments at hand.

Already until May 2010 the European Commission (EFSM), the Euro area Member States (EFSF) and the IMF (stand-by arrangements) were able to cord a robust framework for crisis management with the “€750 bn Financial Stability Package” (see Figure 6).

Figure 6: The first Financial Stability Package to rescue Euro area MS



EU Council Regulation 407/2010
based on Art. 122(2) TFEU
Money from the EU budget

June 2010 – June 2013
Private company under Luxembourg law

Source: EFSF Website: <http://www.efsf.europa.eu/about/index.htm>

EFSM:

This mechanism provides financial assistance to EU Member States in financial difficulties. The European Financial Stabilisation Mechanism (EFSM) essentially reproduces for the EU 27 the basic mechanics of the existing Balance of Payments Regulation (BoP) for non-euro area Member States.

Balance-of-Payments assistance (BoP):

Under the BoP the EU can provide mutual assistance to *non-euro area Member States* when a Member State is in difficulties or is seriously threatened with difficulties as regards its balance of payments. Balance-of-payments (BoP) assistance is designed to ease a country's external financing constraints. This can take the form of medium-term financial assistance. Although the framework of medium-term financial assistance allows providing loans solely by the EU, in recent practice the assistance has usually been extended in co-operation with IMF and other international institutions or countries. Hungary (in 2010), Latvia (2012) and Romania (2011 and 2013) have taken this assistance.

The possibility of granting mutual assistance to a Member State with difficulties as regards its balance of payments is laid down in Article 143 of the Treaty. The facility to provide medium-term financial assistance has been established by Council Regulation (EC) No 332/2002.

Source: http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/index_en.htm

Under EFSM, the Commission is allowed to borrow up to a total of €60 billion in financial markets on behalf of the Union under an implicit EU budget guarantee. The Commission then on-lends the proceeds to the beneficiary Member State. This particular lending arrangement implies that there is no debt-servicing cost for the Union. All interest and loan principal is repaid by the beneficiary Member State via the Commission. The EU budget guarantees the repayment of the bonds through a p.m. line in case of default by the borrower.

The EFSM has been activated for Ireland and Portugal, for a total amount up to €48.5 billion (up to €22.5 billion for Ireland and up to €26 billion for Portugal), to be disbursed over 3 years (2011 – 2013; see Table 2).

The EFSM is a part of the wider safety net. Alongside the EFSM, the European Financial Stability Facility (EFSF), i.e. funds guaranteed by the euro area Member States, and funding from the International Monetary Fund (IMF) are available for euro area Member States. Non-euro area Member States are also eligible for assistance under the Balance of Payments Regulation (BoP).

The European Commission is empowered to contract borrowings on behalf of the European Union for the purpose of funding loans made under the EFSM (Article 2 of Council Regulation 407/2010) contributing the overall loan packages for Ireland and Portugal, which are co-funded by the EU, the EFSF, and the IMF, each acting independently but in a coordinated way.

*EFSF*¹⁵

The European Financial Stability Facility (EFSF) was created in response to the unprecedented financial crisis that began in 2008 and escalated into the “Euro crisis” in 2010. As the financial difficulties experienced by Member States could present a threat to the financial stability of the European Union as a whole, it was deemed prudent to establish the EFSF, as part of a wider safety net, to provide temporary stability support to Euro-area Member States.

The objective of the EFSF is to preserve the financial stability of the Economic and Monetary Union by providing temporary stability support to Euro area Member States. It is a société anonyme set up under Luxembourgish law on 7 June 2010, as part of the May 2010 package, mandated to provide financial assistance on a temporary basis and thus able to enter into new programmes only until 30 June 2013; although the EFSF will continue to service existing commitments thereafter.

The EFSF provides financial assistance to Euro area Member States, linked to appropriate conditionality. It obtains financing by issuing bonds or other debt instruments on the financial markets backed by guarantees of the shareholder Member States. These guarantees total €780 billion. A Member State subject to EFSF financial assistance may request an opt-out of the guarantee structure, thus effectively requesting that its guarantees are no longer used for any future lending. As a result of the Greek, Irish and Portuguese programmes, the EFSF has effective guarantees totalling €726 billion that provide a lending capacity of €440 billion.

The EFSF is authorised to use a number of instruments linked to appropriate conditionality to best serve the needs of a Member State seeking temporary stability support:

- Provide loans to Member States in financial difficulties;
- Intervene in the debt primary and secondary markets;
- Act on the basis of a precautionary programme;
- Provide loans to governments for the purpose of recapitalisation of financial institutions

Each instrument is underpinned by a Memorandum of Understanding (MoU) that details the appropriate conditions a Member State has negotiated with the European Commission, in liaison with the European Central Bank, for financial support as well as the monitoring and surveillance procedures to ensure a Member State is implementing said conditions and returned to normal functioning. EFSF lending is ranked *pari passu* with other creditors. This surveillance is undertaken by inspectors of the so-called “Troika”, made up of the European Commission, the

¹⁵ See: European Commission: http://ec.europa.eu/economy_finance/european_stabilisation_actions/efsf/index_en.htm; and EFSF Website: <http://www.efsf.europa.eu/about/index.htm>

European Central Bank and the International Monetary Fund. The Troika regularly makes report on the success of the countries assisted by the EFSF (Greece, Ireland and Portugal)¹⁶.

In addition, the Heads of State or Government of the euro area Member States agreed on 26 October 2011 to maximise the capacity of the EFSF (increase its “firepower”) by providing two additional lending mechanisms (see Euro area, 2011A):

- *Sovereign partial risk protection*: The EFSF would provide a partial protection certificate to newly issued bonds of a Member State. The certificate would give the holder a fixed credit protection of 20-30% of the principle amount of the bond.
- *Co-Investment Fund*: The creation of a Co-Investment Fund would allow a combination of public and private funding which would then be used to purchase bonds on either the primary and secondary markets on behalf of a beneficiary Member State.

ESM

With their conclusions the Heads of State and Government (see European Council, 2011; “Term Sheet on the ESM”, Annex II) decided in March 2011 to establish a permanent “rescue umbrella” for the Eurozone¹⁷. For this purpose they created the ESM (see ESM Treaty, 2012), the European Stability Mechanism (ESM) between the 17 Euro zone member states – originally planned to become effective in July 2013 and replacing the EFSF (For a comparison of ESM and EFSF, see Figure 7).

The seat of the ESM is Luxembourg. It was legally secured by amending Article 136 TFEU (replacing the reference to Article 122(2)) which had to be ratified by all 27 EU member states. The ESM Treaty is constructed similar to IMF arrangements with preferred creditor status and private sector involvement (in line with IMF practice CAC – Collective Action Clauses – are included). The ESM can operate on primary and secondary bond markets. The ESM, its assets, income and property is exempted from taxes. The ESM Treaty is open for accession by other of the 27 EU member states.

Article I of the ESM Treaty calls this intergovernmental treaty based on international law as an “*international financial institution*” – the possible forerunner to a European Monetary Fund (EMF)!

¹⁶ The documents of the MoU and the programme reports of the “Troika” can be found on the Website of the European Commission (http://ec.europa.eu/economy_finance/assistance_eu_ms/greek_loan_facility/index_en.htm) and on the Website of the IMF “The IMF and Europe” (<http://www.imf.org/external/region/eur/index.aspx>)

¹⁷ The European Council agreed already on 17 December 2010 on the need for euro area Member States to establish a permanent stability mechanism.

On 27 November 2012, the European Court of Justice confirmed that the ESM Treaty is in line with EU law as it stands¹⁸. Prior to this the German Court of Constitution (Bundesverfassungsgericht, 2012) in its “ESM judgement” gave “green light” with regard to German constitutional law. As a result, the euro area’s permanent financial backstop, the European Stability Mechanism (ESM), was signed on 2 February 2012 and was finally inaugurated on 8 October 2012, and is now fully operational following completion of ratification of the ESM Treaty by all euro area Member States. The ESM is the world’s most capitalized international financial institution and the world’s biggest regional firewall (€500 bn). Its creation is a key step for ensuring that the euro area has the capacity needed for rescuing Member States experiencing financial difficulties from default (see Barroso Plan, 2012, p. 7).

Figure 7: ESM and EFSF compared

	ESM	EFSF
Legal structure	Intergovernmental institution under international law	Private company under Luxembourg law
Duration	Permanent institution	Temporary (June 2010 – June 2013*) * applies to new support programmes
Capital structure	Authorised capital stock of €700 billion divided into: €80 billion in paid-in capital €620 in committed callable capital	Backed by guarantees of euro area Member States for up to €780 billion
Capital contribution vs. guarantee scheme	Obligation to contribute to paid-in capital stock not affected if Member State requests or receives financial assistance	Member States may ‘step out’ of guarantee scheme when they request financial assistance
Max. lending capacity	€500 billion	€440 billion
Claims to loans	Preferred creditor status (only junior to IMF)	Pari passu

Source: ESM Website (ESM Factsheet): <http://www.esm.europa.eu/>

The ESM will be the primary support mechanism to Euro area Member States. It will issue bonds or other debt instruments on the financial markets to raise capital to provide assistance to Member States. Unlike the EFSF, which was based upon euro area Member State guarantees, the ESM will have total subscribed capital of €700 billion provided by euro area Member States. €80 billion of this will be in the form of paid-in capital with the remaining €620 billion as callable capital. This subscribed capital will provide a lending capacity for the ESM of €500 billion.

¹⁸ ECJ Judgment as of 27 November 2012 in case C-370/12 Pringle (see ECJ, 2012). The Court also confirmed the validity of European Council Decision 2011/199/EU amending Article 136 TFEU and that the Member States were free to conclude and ratify the ESM Treaty before the entry into force of that Decision.

Financial assistance from the ESM will in all cases be activated upon a request from a Member State (the first country was Spain) to the Chairperson of the ESM's Board of Governors and will be provided subject to conditionality appropriate to the instrument chosen. The initial instruments available to the ESM have been modelled upon those available to the EFSF:

- Provide loans to a Euro area Member State in financial difficulties;
- Intervene in the debt primary and secondary markets;
- Act on the basis of a precautionary programme;
- Provide loans to governments for the purpose of recapitalisation of financial institutions

Each instrument will be linked to a Memorandum of Understanding (MoU) that details the appropriate conditions a Member State has negotiated with the European Commission, in liaison with the European Central Bank, for financial support as well as the monitoring and surveillance procedures to ensure a Member State is progressing towards financial stability. Similarly to the procedure in the surveillance of the MoU of the EFSF (Greece, Ireland and Portugal), the compliance with the MoU under the ESM is surveilled by inspectors of the so-called “Troika”, made up of the European Commission, the European Central Bank and the International Monetary Fund.

Overall, the ESM provides substantial advantages for all participants, thanks to its more robust capital and enhanced governance structure. It will be able to react quickly and decisively to financially support Member States in difficulty; it will be more insulated from the rating migration of Member States; and assistance provided by the ESM will not be rerouted to Member States in public finance statistics.

From ESM to EMF

It is quite realistic – although not necessary - that the permanent European Stability Mechanism (ESM) could – in the near future – be transferred into a European Monetary Fund (EMF). In Article 1 of the ESM Treaty (2012) this is already indicated by the kind of naming the ESM: “*By this Treaty, the Contracting Parties establish among themselves an international financial institution, to be named the "European Stability Mechanism"*”.

The ESM has already many similarities with the IMF, in particular the fact that the Euro area member states pay in capital to the ESM and that many elements of IMF practice are included in the ESM treaty like the CAC and a preferred creditor status.

Shortly after the outbreak of the Euro crisis at the beginning of 2010 many experts thinking about solutions for solving the crisis thought of a similar institution as the IMF for the world – a kind of a “European Monetary Fund” (EMF). The European political leaders only gradually swung to that idea. Firstly, they founded ad hoc instruments like the EFSF, then the permanent ESM which in the end could lead to an EMF.

EMF

The literature is full of ideas how to create an EMF. Mayer (2009) was the first¹⁹ who advocated this idea in order to foster greater integration after the GFC 2008/09. The establishment of a European Monetary Fund (EMF) as a platform to coordinate national fiscal policies with each other and with monetary policy, and to provide funding to countries in financial distress, would meet both the demands emanating from the present crisis and the need to improve the stability of EMU in the long term. Mayer (2009, p. 140) dubbed this institution EMF because of the similarities it could share with the IMF. These would include: (1) professional surveillance of countries' economic policies; (2) financial assistance in times of stress under strict policy conditionality; and (3) peer review of policies and peer control of financial assistance.

However, there would also be significant differences to the IMF: (1) the EMF would act as a lender of last resort to EU (or Euro area) countries only; (2) EMU countries would commit themselves to accept EMF rulings on economic policy as binding (with fines for violations similar to those of the Stability and Growth Pact); and (3) the EMF would be a platform for fiscal policy coordination among EMU.

Rescue, Bail-out measures so far

In the wake of the GFC 2008/09 and in particular starting with the Greek crisis at the beginning of 2010 the “Euro crisis” started to evolve. The EU had no crisis instruments at hand to solve the sovereign debt crises in Greece and other PIIGS countries. Starting with the rescue of Greece early in 2010, Ireland and Portugal followed. In 2012 a banking restructuring package has been put in place for Spain. Circumventing the “No-bail-out clause” of Article 125 TFEU the Heads of States or Government invented (intergovernmental) ad hoc instruments to assist the most indebted countries with high spreads of their government bonds. These rescue measures were done in cooperation with the IMF which had already such stand-by instruments at hand.

The successive rescue operations at Euro area level, starting with Greece and preliminarily ending with Spain are compiled in Table 2. Additional requests by Cyprus to rescue their banking system (amounting to around €17 bn) are still to be decided. The most difficult “patient” is Greece. Whereas the rescue packages for Ireland and Portugal seem to be enough to solve their debt crisis, the Greek case is far more serious (see Breuss, 2012C) because of an extremely deep recession and high unemployment. Due to the prolonged recession it could not fulfil all conditions of the MoU and needed already two rescue packages (May 2010 and March 2012) with “haircut” measures and adjustments in December 2012 (including “debt buy-back” operations and de facto “haircuts” via passing on ECB profits from the Euro area Member States to Greece).

¹⁹ Others followed in advocating a EMF: Gros-Mayer (2010), De Grauwe (2011A) and Schulmeister (2011).

Table 2: Rescue Measures for Greece, Ireland, Portugal and Spain

Countries	MoU of adjustment programmes	Kind of assistance	FAP volume € billion	Aid for 3 yr plan	Already disbursed € billion
Greece	2 May 2010	Eurogroup (GLF)	80.0		52.9
		IMF (SBA)	30.0	5/2010	20.1
	Total	1st FAP	110.0	to 6/2013	73.0
	14 March 2012 (MoU)	Eurogroup (EFSF)	144.7	<i>(incl. undisbursed</i>	108.3
		IMF (EFF)	19.8	<i>GLF)</i>	4.8
Total	2nd FAP	164.5	2012-2014	113.1	
	<i>Additional: 50% "haircut" of PSI</i>	100.0			
	Dec. 2012	3rd FAP (2nd FAP+) Greece: debt buy-back operation (DBBO) Eurogroup concessions (EGC): 27/11/2012	31.9	<i>(disbursement out of 2nd FAP)</i>	43.7 (12/2012 34.4)
Ireland	7 Dec 2010	Ireland (Treasury+PRF)	17.5		17.5
		EFSM	22.5		21.7
		EFSF (+bilateral loans from UK, DK, SW)	17.5		12.1
		IMF	5.0		5.0
		Total	FAP	85.0	2010-2013
Portugal	17 May 2011	EFSM	26.0		22.1
		EFSF	26.0		18.2
		IMF	26.0	2011	21.1
		Total	FAP	78.0	to mid 2014
Spain	5 Dec 2012	EFSF + ESM (Financial sector assistance)	100.0	7/2012- to 6/2013	39.5

FAP = Financial Assistance Programmes; GLF = Greek Loan Facility – bilateral loans pooled by the European Commission; SBA = Stand-by arrangement by the IMF; MoU = Memorandum of Understanding; PSI = Private Sector Involvement; EFF = Extended Fund Facility for Greece; EFSM = European Financial Stabilisation Mechanism, administered by the European Commission (part of EU budget, total €60 bn); EFSF = European Financial Stability Facility; ESM = European Stability Mechanism.

Sources: European Commission (Financial Assistance in EU Member States: http://ec.europa.eu/economy_finance/assistance_eu_ms/index_en.htm) and EFSF (<http://www.efsf.europa.eu/about/index.htm>) and ESM (<http://www.esm.europa.eu/>)

ii) Elements of a European “Banking Union”

As the Euro crisis has a threefold causation it is not enough just to fix the flaws concerning the sustainability of public finances and lack of competitiveness (repairing with the new governance instruments towards a “Fiscal Union”) but also to re-regulate the previous unregulated financial sector (measures ranging from new surveillance instruments towards a genuine “European Banking Union” (see the compilation in Figure 8).

Surveillance of Financial Markets

Getting Europe back on track also requires a healthy financial sector. Therefore, the EU established a new financial supervision architecture in January 2011²⁰. It includes:

a) *European Systemic Risk Board (ESRB)*: The ESRB is an independent EU body responsible for the macro-prudential oversight of the financial system within the Union. Its seat is in Frankfurt on the Main. Its secretariat is ensured by the ECB; and

b) *Three European supervisory authorities* (into force as of 1 January 2011):

b1) European Banking Authority (EBA): The European Banking Authority was established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council on 24 November 2010. The EBA has taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS). The EBA acts as a hub and spoke network of EU and national bodies safeguarding public values such as the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors. Bank stress tests have been conducted by the EBA. Its seat is in London.

b2) European Insurance and Occupational Pensions Authority (EIOPA): EIOPA is an independent advisory body to the European Parliament and the Council of the European Union. EIOPA’s core responsibilities are to support the stability of the financial system, transparency of markets and financial products as well as the protection of insurance policyholders, pension scheme members and beneficiaries. EIOPA is based in Frankfurt on the Main, Germany.

b3) European Securities and Markets Authority (ESMA): ESMA is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors by working closely with the other

²⁰ See the Website of the European Commission: http://ec.europa.eu/economy_finance/economic_governance/index_en.htm

European Supervisory Authorities competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA). The seat is Paris.

Financial services regulations

The European Commission has adopted a number of initiatives as a response to the crisis in the area of financial services regulations under the “Single Market Programme”²¹. Besides the “supervision of the financial sector”, the Commission is working on measures to increase protection for bank deposits; to strengthen capital requirements for financial firms (CRD IV package²² which implements the broader rules of BASEL III), to make credit ratings (credit rating agency reforms) more reliable, to tighten rules on hedge funds, short selling and derivatives, to revise current rules on MiFID (Markets in Financial Instruments Directive), market abuse and UCITS (Undertakings for Collective Investment in Transferable Securities), to curb banking pay practices that encourage recklessness, to reform the sectors of audit and accounting and several proposals for directives concerning national actions in the financial markets (see Figure 8).

European Banking Union (EBU)

The Euro area summit held on 29 June 2012 (see Euro area, 2012B) marked a turning point in the approach to the crisis. It recognised the "imperative" need to "break the vicious circle between banks and sovereigns" that is weakening the finances of Euro area countries, to the point of threatening the very existence of the EMU. In particular, the agreement to set up a Single Supervisory Mechanism (SSM) was based on the conviction that financial fragmentation must be overcome and that the centralisation of banking supervision is necessary to ensure that all Euro area countries can have full confidence in the quality and impartiality of banking supervision (see the roadmap towards a true European Banking Union in Figure 8).

A true Economic and Monetary Union – and hence a functioning Single Market - must indeed include shared responsibility for policing the banking sector and intervening in case of crises²³.

²¹ Details on the concrete measures of financial services regulation, see the Website of the European Commission (“The EU Single Market”): http://ec.europa.eu/internal_market/finances/policy/map_reform_en.htm

²² In the course of an agreement on CRD IV (28 February 2013) between EU country representatives (Irish presidency) and the European Parliament also a “breakthrough” deal to cap banker’s *bonuses* has been reached. Accordingly, bankers face an automatic cap on bonus payouts at the level of their salaries (1:1 rule). If a majority of a bank’s shareholders vote in favour, that ceiling can be raised to two-times pay.

²³ For further details (the legal proposals of the European commission) on the “Banking Union”, consult the Website of the European Commission – “The EU Single Market”: http://ec.europa.eu/internal_market/top_layer/financial_capital/index_en.htm; and all necessary information on the Euro area, one can find on the “Eurozone Portal”: <http://www.eurozone.europa.eu/>

This is the only way to effectively break the vicious circle linking Member States' public finances and the health of their banks, and to limit negative cross-border spillover effects.

Figure 8: A Roadmap towards a European Banking Union – From SSM to a genuine EBU

	Single Supervisory Mechanism (SSM)	Common Deposit Protection (CDP)	Single Bank Resolution Mechanism (SBRM)
Implementation	2014	2015 + ?	2015 + ?
European (Euro area) level	<p>ECB</p> <p>ultimate responsibility for Euro area bank supervision cooperation with EBA</p> <p>coverage: Euro area banks (6.000)</p> <p>Non-Euro area banks ?</p>	<p>CDP</p> <p>Common (single) Deposit Guarantee at EU (Euro area) level is future project</p> <p>Political opposition in Nordic countries of Euro area</p> <p>strong support in Euro area periphery</p>	<p>SBRM</p> <p>European Authority (ECB ?)</p> <p>is future project</p> <p>EBA</p> <p>cooperation with MS in DR-06/2012</p>
National level	<p>National supervisory authorities</p> <p>in cooperation with ECB</p>	<p>DR-7/2010</p> <p>National Deposit Protection since end of 2010: EUR 100.000 in all EU MS (applies to all aggregated accounts of one account holder at the same bank)</p>	<p>DR-06/2012</p> <p>financed by Resolution Funds (RFs) and Deposit Guarantee Schemes (DGS)</p> <p>optimal target size for DGS and RFs at least 1% of covered deposits held by EU banks</p>
Legal provisions	<p>CRD IV Package</p> <p>bank capitalisation into effect '01/01/2013</p> <p>BASEL III implementation in EU</p> <p>SSM</p> <p>into effect '01/01/2014</p>	<p>DR-7/2010</p> <p>New deposit guarantee schemes (DGS) (European harmonisation)</p> <p>proposal by the Commission 10/07/2010</p>	<p>DR-06/2012</p> <p>for the recovery and resolution of credit institutions and investment firms</p> <p>proposal by the Commission 06/06/2012</p>

CRD = Capital Requirements Directive (1 DR + 1 RE); SSM = Single Supervisory Mechanism (1 RE ECB; 1 RE EBA-ECB); DR = Directive; RE = Regulation.

Source: Breuss (2012B).

The European Council (see European Council, 2012) on its summit in December 2012 agreed on a roadmap for the completion of the EMU, based on deeper integration and reinforced solidarity. This process will begin with the completion, strengthening and implementation of the new enhanced economic governance, as well as the adoption of the Single Supervisory Mechanism (SSM) at the ECB level²⁴. As a first step the SSM should be able to start as of 2014²⁵. After the

²⁴ An alternative proposal for a SSM not installed at the ECB but administered by an independent body is made by the Sachverständigenrat (2012B, 3rd chapter: "Financial markets in Europe: from the Single Market to a Banking Union").

²⁵ The SSM can be legally established based on Article 127 paragraph 6 TFEU

establishment of the SSM at the ECB, the next steps towards a true “Banking Union” will be rules on recovery and resolution of banks (SBRM) and on deposit guarantees (CDP; see Figure 8). The establishment of an effective SSM is also the precondition of a direct bank recapitalisation in the Euro area by the ESM (see European Council on EMU, 2012).

Rating Agencies:

During the Euro crisis many European governments got the impression that the US-American based Rating Agencies are evaluating the periphery countries of the Euro area to strict so that they contributed to a deepening of the crisis. Therefore, starting on February 2012 the European Commission initiated several legal proposals to watch the activities of the Rating Agencies²⁶. New rules on when and how credit rating agencies may rate state debts and private firms’ financial health were approved on 16 January 2013 by the European Parliament. They will allow agencies to issue unsolicited sovereign debt ratings only on predefined dates, and enable private investors to sue them for negligence.

3.2 More “Europes” after the crisis instead of “more Europe”?

The Euro crisis is not only an economic and institutional challenge it had also tremendous political collateral damages. Five to seven governments collapsed and in two countries (in Greece and Italy) the elected prime ministers had to be replaced by economic experts.

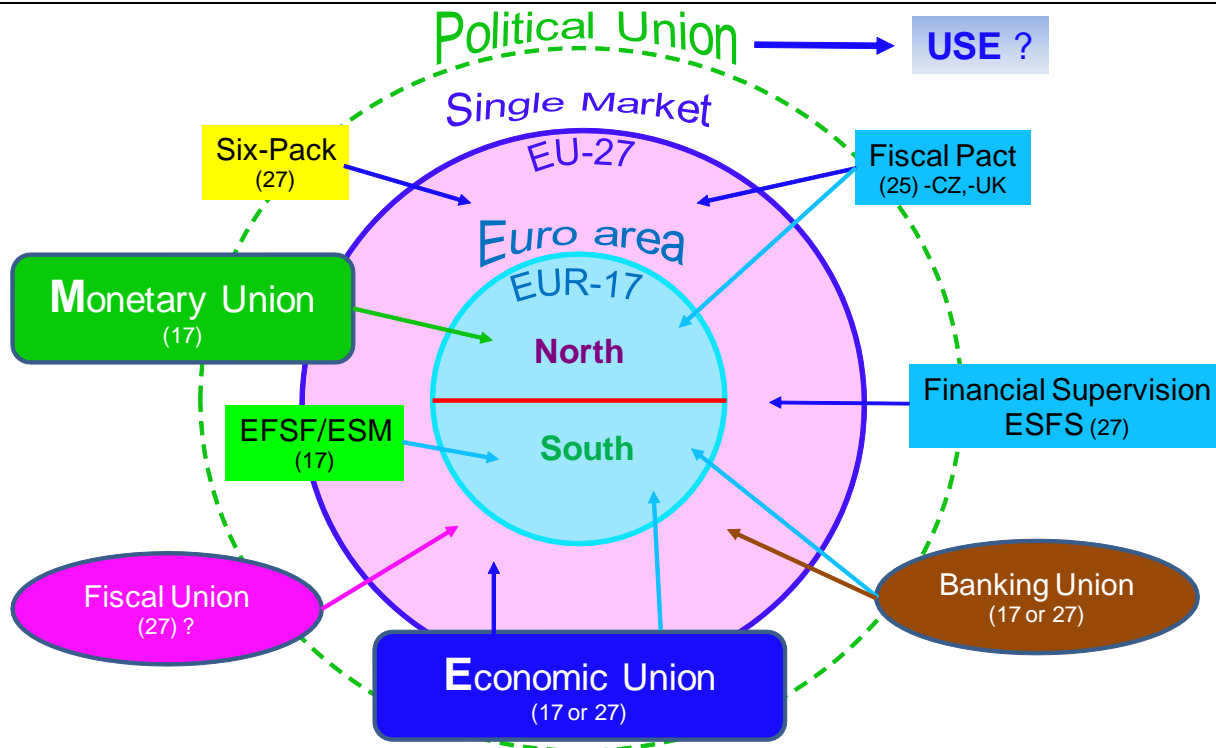
The crisis also amplified the fact that the European Union is divided already not only in two but in multiple parts with different (integration) speed. Think only of the 25 members of the Schengen passport-free travel zone (excluding Britain but including some non-EU members like Switzerland and Iceland), or of the 25 states seeking to create a common patent (including Britain, but excluding Italy and Spain). And then the Single Market of EU-27 is split into Euro and non-Euro countries. The Euro project started in 1999 with only 11 member states and until now the Euro zone expanded to 17 countries.

When the rescue management of Greece began in spring 2010 the Heads of State or Governments of the Euro zone developed one measure after the other, firstly ad hoc aid for Greece, then came the rescue funds EFSF and ESM and a second rescue package for Greece. All these measures were developed at the summits of the Eurozone (Euro Group). The donors for Greece, Ireland and Portugal were primarily the member states of the Eurozone plus means out of the general EU budget (EFSM) and the IMF. The non-Eurozone countries stood aside. They had nothing to say in the Euro Group debates and they contributed nothing directly to help the indebted Eurozone

²⁶ See the legal activities of the European Commission on its “Single Market” Website: http://ec.europa.eu/internal_market/securities/agencies/index_en.htm

countries. As a speciality of the rotating presidency of the European Council it can happen (as in the case of the Polish and Danish presidency) that the presidents of the non-Euro area countries have no say in the process of solving the current acute problems of the Euro area.

Figure 9: More “Europes” or “more Europe”?
(Centralisation vs Europe à la carte?)



ESFS = European system of financial supervisors; EFSF = European Financial Stabilisation Mechanism; ESM = European Stability Mechanism

Source: Author's conception, see also Breuss (2012B, p. 28).

In the near future the institutional setting of the European Union will be one of a tripartite nature (see Der Standard, 2012, p. 2). The Union converges to one of concentric circles. The outer circle consists of the European Council summits of the 27 EU (since 2013 28) member states. Then there will be the summits of the 17 plus countries of the “Euro Plus Pact” and/or those of the “Fiscal Pact” (at the moment 25 EU member states). And lastly there are the special summits of the Euro Group of the 17 member states with the Euro (see Figure 9).

The Economist (2011) quoted comments made by Nicolas Sarkozy during a debate with students at the University of Strasbourg where he calls for a two-speed Europe: a “federal” core of the 17 members of the Eurozone, with a looser “confederal” outer band of the ten non-euro members. Life after the “Fiscal Pact” even speaks for a further splitting-up into “three Europes”.

The most recent development of the Euro crisis reawakens the idea of a “Kerneuropa” (“core Europe”) promoted already in 1994 by Karl Lamers and Wolfgang Schäuble (1994). However, today this would imply a downsizing of the Euro zone to countries with a more homogenous economic performance than those of the 17 Euro member states with a homogeneous and highly developed North and an “underdeveloped” South or Periphery.

Anyway, the current trend goes to “more Europes” instead of a more united Europe up to the “United States of Europe” (USE). However, as will be demonstrated later, a well functioning EMU calls for more Europe in the sense of a more centralized economic union with more EU level competence²⁷.

4. WHAT KIND OF “EMU” IN A FUTURE EU?

Bearing in mind the fundamental flaw of the EMU, namely that it rests on the principle “one market, one money” instead of “one country, one money” one has to look for remedies to bridge this gap²⁸. When EMU has removed the exchange rate as an adjustment mechanism to external shocks, member countries should have used alternative adjustment instruments (“internal” devaluation; flexibility in the labour markets using the freedom to move in EU’s Single Market etc.) in the spirit of the Optimum Currency Area (OCA) theory. The Euro crisis, however, shows that this not happened (at least not in all) members of the Euro area. The necessary adjustment only happens during the crisis via austerity measures and last but not least the Eurozone, being (not yet) a real OCA mutates into an artificial OCA maintained by transfers from the Nord to the South (via a fiscal “Transfer Union”; see the theoretical and graphical demonstration in Breuss, 2011C)²⁹.

In the following chapters we deal with the most recent proposals for a new and crisis-proof EMU governance or the new institutional set-up of a genuine EMU, respectively.

²⁷ However, not all EU Member States are willing to follow these ambitions towards more unification of the EU. Prime Minister David Cameron (2013) made this clear in his speech on “Britain and Europe” where he points into another direction of a reformed EU: not an ever closer Union is his target but a more flexible Europe – Europe à la carte – which would play a major role in a globalized world.

²⁸ Valuable information about the ongoing reform steps and actions of the Euro area can be found on the “EUROZONE PORTAL – The official gateway to the euro area”: <http://www.eurozone.europa.eu/>

²⁹ A historically funded discussion how the Eurozone could become at last a functioning OCA can be found in Handler (2013).

Primarily the two new plans – one by the European Commission (“Barroso” plan) and one by the president of the European Council (“Van Rompuy” plan) – are put forward. Both plans overlap somewhat which is no wonder, worked all participating institutions and persons somehow together.

4.1 The „Barroso“ Plan for a deep and genuine EMU

The plan by the European Commission for a deep and genuine EMU (for short “Barroso” plan (2012) or “blueprint”) collects previous reform steps, suggestions made in the “State of the Union 2012 Address” by Barroso (2012) and new EMU governance elements already implemented or on the way to be implemented (see the compilation in Figures 3) and puts forward new far-reaching proposals which would lead to a “Political Union”. These proposals are embedded into a roadmap (blueprint) with a timetable for work to be finished in the short, the medium and the longer term. Additionally the suggestions are evaluated to which degree they can be realized without Treaty change (by secondary law) and which need Treaty change (see Figure 10).

The far-reaching proposals of the “Barroso” plan (and also those of the “Van Rompuy” plan), however, were politically too precocious for the Heads of State or Government. Therefore the European Council (2012) decided to postpone these deepening proposals, except the implementation of the SSM as a first step towards a European Banking Union.

The reform work so far:

After describing the rationale, inspirations, and the benefits of EMU the “blueprint” repeats the weaknesses in the initial design of EMU and adherence to rules. The measures taken so far (see the compilation in Figure 3) were a crisis response (crisis management). The ingredients of the Euro crisis management consists of a new budgetary surveillance (“Six-Pack” and “Two-Pack”) and economic policy surveillance (MIP and EIP) as well as the financial regulation and supervision (ESFS). The crisis resolution mechanisms (EFSM, EFSF, ESM) were newly created rescue umbrellas. On the monetary side the ECB has played a crucial role in the Euro area response to the crisis by applying new and unconventional measures (see more in chapter 4.3). The Commission adheres that the EMU has been overhauled, but that the work is not yet complete.

The way forward: combining substantial ambition with appropriate sequencing:

The European Council in June 2012 invited the President of the European Council (Herman van Rompuy), in close collaboration with the President of the Commission (José Manuel Barroso), the President of the Euro Group (Jean-Claude Juncker) and the President of the ECB (Mario

Draghi), to present a specific and time-bound roadmap for the achievement of a genuine EMU. An interim report was presented to the October European Council, and a final report (the “Van Rompuy” plan) was presented at the European Council meeting in December 2012. The European Parliament adopted on 20 November its report "Towards a genuine Economic and Monetary Union", which outlines the Parliament’s preferences for a more deeply integrated EMU. The Commission's proposal on the way forward is outlined in this blueprint.

The “blueprint” is a comprehensive vision to transform the present flawed EMU into a deep and fully integrated version, in particular considering the significant additional transfer of political powers from the national to the European level and hence creating a “Political Union”³⁰. In the following the major ingredients of the “Barroso” plan (2012) is presented and discussed.

The roadmap for a new EMU:

(i) In the short-term:

All proposals in the short-term are manageable without Treaty change by secondary law based on the Lisbon Treaty. In the short-term the current economic governance framework must be completed. This includes a full implementation of European Semester and “Six-Pack” and a quick agreement and implementation of the “Two-Pack”. Further the financial regulation and supervision must be completed by a single rulebook and the implementation of the proposals for a Single Supervisory Mechanism (SSM), a first step towards a Banking Union. An effective banking union requires not only a SSM ensuring high quality supervision across Member States, but also a Single Resolution Mechanism to deal with banks in difficulties. For a functioning Union a quick decision on the next Multi-annual Financial Framework (MFF) for the years 2014 to 2020 is decisive. At the European Council (2013) meeting on 7 and 8 February 2013 an agreement has been reached on the MFF 2014-2020 by the Heads of States or Government. This agreement has still to be approved by the European Parliament.

A novel feature is the creation of a “*Convergence and Competitiveness Instrument*” (CCI³¹). By the CCI³² (which may be implemented in the next MFF) the existing framework for economic governance of the Euro area should be strengthened further through ensuring greater ex-ante coordination of major reform projects. When Member States fail to take appropriate action to reform their economies (e.g. to improve competitiveness), large spillover effects within the currency union call for such a more stringent process of economic policy coordination for Euro

³⁰ Other proposals to fundamentally reform the EMU governance are put forward in Aiginger et al. (2012).

³¹ Details on CCI can be found in the Annex 1 to the “Barroso” plan (2012).

³² In her speech at the World Economic Forum in Davos on 24 January 2013, Chancellor Angela Merkel proposed a “*Pact for Competitiveness*” for the Euro area to achieve a convergence – a “European business cycle”. This proposal is, however a remake of an old proposal made by Merkel and Sarkozy already in January 2011 (see Breuss, 2011B, p. 13). This pact changed gradually its name and ended lastly in “Euro Plus Pact” (see Figure 3).

area Member States. On the basis of the current Treaties, the legislator could therefore set up an integrated framework for the surveillance of economic policies consisting of two elements:

1) A mechanism for systematic ex ante coordination of all major reform projects of Member States in the context of the European Semester, envisaged in Article 11 of the TSCG.

2) A Convergence and Competitiveness Instrument (CCI) in the framework of the Macroeconomic Imbalances Procedure (MIP) based on contractual arrangements between Commission and Euro area Member States coupled with the possibility of financial support.

The CCI would complement the MIP and the existing framework for the surveillance of the budgetary situation of the Member States (the SGP). Its objective would be twofold: first it would reinforce the existing procedures in particular by strengthening ex ante coordination of major economic reforms; second, it would strengthen the dialogue with the Euro area Member States to enhance national ownership through the introduction of contractual arrangements to be concluded between the Commission and Member States. It would be coupled by a dedicated system of financial support, representing the initial phase of the build-up of a “fiscal capacity” for the EMU.

The primary concern in the Euro crisis is the intolerable high rate of unemployment – in particular in the periphery countries. Therefore, as recommended in the Annual Growth Surveys 2012 and 2013 (in the context of the European Semester procedure), the Member States should strive in particular to maintain an adequate fiscal consolidation pace while preserving investments aimed at achieving the “Europe 2020” goals for growth and jobs³³.

Another point of interest is the external representation of the Euro area, in particular in the IMF.

(ii) In the medium-term:

The medium term should see the establishment of further budgetary coordination (including the possibility to require a revision of national budgets in line with European commitments), the extension of deeper policy coordination to the fields of taxation and employment and the creation of an autonomous, proper “fiscal capacity” for the EMU to support the implementation of the policy choices resulting from the deeper coordination. Some of these elements will require amending the Treaties.

³³ In the MFF 2014-2020 a Youth Employment Initiative has been created to add to and reinforce the support already provided through the EU structural funds. The initiative will be open to all regions (NUTS level 2) with levels of youth unemployment above 25%. It will act in support of measures set out in the youth employment package proposed by the Commission in December 2012 and in particular to support the Youth Guarantee following its adoption. The support for the Initiative will be EUR 6 000 million for the period 2014-2020.

Besides the deepening of budgetary and economic integration, the “blueprint” proposed for the medium-term new instruments, which were, however, discussed in academic circles already for a while:

- (1) A proper “Fiscal capacity” for the Euro area;
- (2) A “European Redemption Fund” (ERF), and;
- (3) Eurobills.

Figure 10: The roadmap to a better EMU of the “Barroso” plan

			A blueprint for a deep and genuine EMU Launching a European debate		Secondary law	Treaty change
ALL ALONG THE PROCESS	SHORT TERM	Within the next 18 months	1. Full implementation of European Semester and six-pack and quick agreement on and implementation of two-pack		✓	
			2. Banking Union : Financial regulation and supervision: quick agreement on proposals for a Single Rulebook and Single Supervisory Mechanism		✓	
			3. Banking Union : Single Resolution Mechanism		✓	
			4. Quick decision on the next Multi-annual Financial Framework		✓	
			5. Ex-ante coordination of major reforms and the creation of a Convergence and Competitiveness Instrument (CCI)		✓	
			6. Promoting investment in the Euro Area in line with the Stability and Growth Pact		✓	
			7. External representation of the Euro Area		✓	
	MEDIUM TERM	18 months to 5 years	1. Further reinforcement of budgetary and economic integration		✓	✓
			2. Proper fiscal capacity for the Euro Area building on the CCI		✓	✓
			3. Redemption fund			✓
			4. Eurobills			✓
	LONGER TERM	Beyond 5 years	1. Full Banking Union			✓
			2. Full fiscal and economic union			✓
	Political union: Commensurate progress on democratic legitimacy and accountability				✓	✓

Source: European Commission (2012D), “A blueprint for a deep and genuine Economic and Monetary Union: Launching a European debate”, Press Release, Brussels, 28 November 2012, p. 2.

All three instruments would need Treaty change and is therefore not very likely to be realized. Furthermore, the suggestion of an ERF as an immediate crisis tool was developed by the German Council of Economic Experts (GCEE) as part of a euro area-wide debt reduction strategy but was immediately refused by the German government.

Fiscal capacity

The “fiscal capacity” should play the role of a shock-absorber and play a stabilisation function. It is not yet clear how this instrument should work: Shall it be implemented as a separate Euro area budget or will it become part of the central EU budget? As it is proposed in the “blueprint” (see “Barroso” plan (2012), pp. 31-34) it should have the power to raise own taxes (e.g. Financial Transactions Taxes) and should work – in contrast to the automatic stabilizers within the system of “*Fiscal federalism*”³⁴ in the USA and Canada – as a discretionary instrument to absorb shocks.

Stabilisation mechanism à la US fiscal federalism were already proposed at the beginning of the EMU (see Breuss, 2000) but were refused in order not to conflict with the “No-bailout” rule of (now) Article 125 TFEU³⁵. After the repercussions in the wake of the GFC 2008/09 a fiscal transfer mechanism (or a form of an “European Transfer Union – ETU”); see also the early discussion in European Commission (1993), Part 1) is again taken up as a necessary complement to a new EMU.

For the time being the idea of a separate budget (or fiscal capacity) only for the Euro area would lead to a further split of EU integration. Some ideas how this fiscal capacity could be realized were discussed in Wolff (2012) and in Pisani-Ferry et al. (2013).

³⁴ There is already a huge literature on “fiscal federalism”. Early empirical studies found a considerable stabilisation effect of fiscal federation. The overall stabilisation effect of federal budgets for the United States amounted to around 30%-40% (Sachs-Sala-i-Martin, 1992; Bayoumi-Masson, 1995). More recent estimates with Canadian data for the federation and provincial deficits, taxes and transfers by Bayoumi-Masson (1998) reach similar size. Every dollar increase in the federal deficit which is specific to the province in question raises private consumption by 44 cents. An equivalent increase in the federal deficit at the national level or in the provincial deficit raises consumption by 16 cents in the dollar. Henning-Kessler (2012A, 2012B) in their historical study use the US fiscal federalism as a model for Europe. Further contributions to “fiscal federalism” can be found in Ahmad-Brosio (2006), Anderson (2010), Inman-Rubinfeld (1992) and Oates (2005). The OECD has created a “*Fiscal Federalism Network*” at: (http://www.oecd.org/departement/0,3355,en_2649_35929024_1_1_1_1_1,00.html).

³⁵ The finance ministers in the Ecofin Council meeting on May 1, 1998 when suggesting to go ahead with EMU with eleven countries also declared under point 6: “*The Council reiterates that the responsibility for budgetary consolidation lies and remains with the Member States and that, in accordance with the provisions of Article 104b(1) TEC (now Article 125 TFEU), the Community in particular shall not be liable for or assume the commitments of Member States. Without prejudice to the objectives and provisions of the Treaty, it is agreed that Economic and Monetary Union as such cannot be invoked to justify specific financial transfers.*”

European Redemption Fund” (ERF)

In the annual report released on 9 November 2011, the German Council of Economic Experts (GCEE) (see Sachverständigenrat (2011, 2012A); see also Bofinger et al., 2011) has proposed a novel solution to the Euro debt crisis – with the “European Redemption Pact” and an associated “European Redemption Fund”. This would – like Eurobonds – create a joint debt vehicle, but unlike Eurobonds it would be temporary, say 25 years. Its aim would be to ease down the current unsustainable levels while implementing credible fiscal policy reforms in all Eurozone nations.

Resting on provisions made by the revised SGP-III, this would combine joint and several liability and strong individual commitment in refinancing the Euro zone members over the next couple of years and, simultaneously, provide a road map to each member country reaching a 60% debt-to-GDP ratio within another two decades, after which the ERP would be set to expire.

The key idea of the proposal is the separation of the debt that has been accumulated to date by individual member countries of the Eurozone, into a part that is compatible with the 60% debt threshold of the SGP, and a part exceeding this threshold.

Following the sequence of immediate refinancing needs in a roll-in phase stretching over the next couple of years, participants in the Redemption Pact shall be able to refinance themselves through a joint “European Redemption Fund” (ERF), until the amount of debt refinanced through the ERF reaches the current difference between the debt accumulated to date and the hypothetical debt that would just equal 60% of GDP, i.e. the SGP debt threshold.

While each country will henceforth have to service its own debt financed via the new Fund until it is completely redeemed and the new Fund expires, participants will be jointly liable for the debt, thus ascertaining affordable refinancing cost for all participants.

The GCEE stresses that the ERF is not comparable to Eurobonds.

The proposal of an ERF by the German Council of Economic Experts had been welcomed not very heartily by the German government when presenting the annual report. At the current status of the EU as only a “Fiscal Transfer Union” the German government opposes strictly any kind of Euro Bonds (for a critical evaluation, see also Pusch, 2012).

Eurobills

An important effect of the crisis has been the reassessment of sovereign-credit risk within the Euro area. After more than a decade during which Member States could borrow at almost identical conditions, markets started again to differentiate risk premia across countries.

Government securities issued by the weaker Euro area Member States have been traded at considerably higher yields, with adverse consequences for the sustainability of public finances for the sovereigns concerned as well as for the solvency of the financial institutions holding those government securities as assets. This segmentation of credit risk together with the "home bias"

that characterises financial institutions has proved to be a powerful engine of financial fragmentation in the euro area.

There are already many proposals for a mutualisation of financial instruments at EU level, “Euro Bonds” (see Giovannini Group, 2000), “Blue Bonds” versus “Red Bonds” (Delpla and von Weizsäcker (2010, 2011); De Grauwe (2011A); De Grauwe and Moesen (2009) and “Stability Bonds” (European Commission (2011D; critique in Germany, see Neue Zürcher Zeitung, 2011)). There are “Pros” and many “cons” concerning the introduction of “Eurobills”:

As De Grauwe (2011A) and others pointed out, member states when entering EMU have changed the nature of their sovereign debt in a fundamental way, i.e. they cease to have control over the currency in which their debt is issued. In fact governments of the Eurozone countries issue their sovereign bonds now in a “foreign currency”. As a result, financial markets can force these countries’ sovereigns into default. In this sense member countries of the Eurozone are downgraded to the status of emerging economies. This makes the monetary union fragile and vulnerable to changing market sentiments. Interestingly, the bond yield spreads only occurred after the GFC 2008/09 whereas before in the “fair weather period” 1999-2007 the markets rated the risks of the sovereign bonds of all Euro zone countries equal and, hence there were negligible spreads.

Advocates of Eurobonds, like De Grauwe (2011A, p. 26) see in the joint issue of Eurobonds an important step towards political union and thus towards strengthening the Eurozone. A joint issue of Eurobonds would be an important mechanism of internalizing the externalities in the Eurozone. By jointly issuing Eurobonds, the participating countries become jointly liable for the debt they have issued together. This is a very visible and constraining commitment that will convince the markets that member countries are serious about the future of the euro.

The proposal of issuing common Eurobonds has met stiff resistance in a number of countries. Indeed, common Eurobonds creates a number of serious problems (see De Grauwe, 2011A, p. 26):

A first problem is *moral hazard*. The common Eurobond issue contains an implicit insurance for the participating countries. Since countries are collectively responsible for the joint debt issue, an incentive is created for countries to rely on this implicit insurance and to issue too much debt. This creates a lot of resistance in the other countries that behave responsibly.

A second problem (not unrelated to the previous one) is the *cost problem*. It arises because some countries like Germany, Finland and the Netherlands today profit from triple A ratings allowing them to obtain the best possible borrowing conditions. According to ifo estimates (see ifo, 2011) the issue of Eurobonds would cause additional costs for the German budget between €33 bn and €47bn or 1.3% to 1.9% of German GDP. This cost arise because the interest rates Germany would have to pay would increase by 2.3 percentage points compared to around 2% for 10 yrs German government bonds.

Lastly there is the *legal question* of the barrier by the “No-bailout” clause in Article 125 TFEU. Also the Commission in its “blueprint” sees the necessity of Treaty change when Eurobills should be introduced.

Alternative proposals for instruments to fight EU crises

During the debate about “Reforming the EU Budget, changing Europe” in autumn 2008 – shortly after the Lehman Brothers disaster and at the beginning of the Great Recession 2009 - at a conference of the European Commission, Breuss (2008) foresaw that the future EU budget would be confronted with *two new tasks*, namely to react quickly, flexibly and in the short-term to stabilize the economies of the EU. Breuss (2008) suggested two new instruments in the EU budget:

- (1) The EU needs a “*Financial Crisis Fund*”. This fund could be financed by a Tobin tax or Financial Transactions Tax (FTT) (later the European Commission (2011B) proposed such a FTT). Eleven EU Member States are starting to introduce a FTT under Article 20 TEU and Article 236 TFEU (Provisions on enhanced cooperation) in 2014.
- (2) Given the emerging Great Recession of 2009 Europe needs an additional instrument in the EU budget, a „*Stabilization Fund*“. This fund could be created similarly as the existing European Globalisation Adjustment Fund (EGF) or one could (again) think of installing kind of „fiscal federalism“, knowing that this was repelled at the start of EMU on the grounds of possible „moral hazard“ and the violation of Article 125 TFEU (see the arguments in Breuss, 2000). The Stabilization Fund could be financed out of the seigniorage of the ECB and additionally out of an FTT.

Gros and Micossi (2008) proposed a “European Financial Stability Fund” to assist new EU member states in their adjustment process.

(iii) A longer term vision of EMU:

In the longer term, the European Union should move towards a full “banking union”, a full “fiscal union”, a full “economic union”, which all require, as a fourth element, appropriate democratic legitimacy and accountability of decision-making. Major Treaty reform will be required on this path.

“*Banking Union*”: The ingredients for a “Full Banking Union” have already been described earlier (see Figure 8): after installing the SSM, a Single Resolution Mechanism as well as a Common Deposit Protection scheme would complement the European Banking Union.

“Economic Union”: To achieve the goal of an *“Economic Union”*, firstly the EU must create a full *“Fiscal Union”*, consisting of the instruments already in place (Six-Pack, Two-Pack, Fiscal Pact) plus an Euro area budget or a “fiscal capacity” with the task to stabilise uneven business cycle developments in the Euro area. Building on the fiscal capacity, an EMU-level stabilisation tool to support adjustment to asymmetric shocks, facilitating stronger economic integration and convergence and avoiding the setting up of long-term transfer flows, could become a component for a genuine EMU. Such a mechanism would need to be strictly targeted to address short-term asymmetries and cyclical developments in order to *avoid permanent transfers* over the cycle. It must be supportive of structural reforms and be subject to strict political conditionality to avoid moral hazard. In contrast to the automatic stabilizing scheme of the US fiscal federalism this shock-absorber instrument of a Euro area “fiscal capacity” should be applied ad hoc in a regional crisis. It should not lead to a situation that the Euro area becomes a permanent “Transfer Union”.

(iv) Political Union:

The largest flaw in Euro crisis management since 2010 was the fact that most actions were taken intergovernmental without involving the European Parliament. A fundamental EMU reform must therefore improve democratic legitimacy. Any work on democratic legitimacy as a cornerstone of a genuine EMU needs to be based on two basic principles. First, in multilevel governance systems, accountability should be ensured at that level where the respective executive decision is taken, whilst taking due account of the level where the decision has an impact. Second, in developing EMU as in European integration generally, the level of democratic legitimacy always needs to remain commensurate with the degree of transfer of sovereignty from Member States to the European level. This holds true for new powers on budgetary surveillance and economic policy as much as for new EU rules on solidarity between Member States. Briefly put: Further financial mutualisation requires commensurate political integration.

The “blueprint” (for the following, see “Barroso” plan, 2012) discusses ways to optimise accountability and governance in the short and in the longer run.

“Short-run”: In the short-run (without Treaty change) the European Parliament should be involved much stronger than in the past via an Economic Dialogue to foster parliamentary debate in the “European Semester”. The starting point in this respect should be the Economic Dialogue which has been recently set up by the “Six-Pack” and which provides for discussions between the European Parliament, on the one hand, and the Council, the Commission, the European Council and the Eurogroup on the other hand. Furthermore, the European Parliament should be regularly informed of the preparation and implementation of the adjustment programmes concerning Member States receiving financial assistance, as foreseen in the “Two-Pack”.

“In the long-run – Treaty change”:

In the context of a Treaty reform conferring further supranational powers to the EU level, the following steps should be considered to ensure a commensurately stronger democratic accountability:

- (1) For the sake of visibility, transparency and legitimacy, the current Broad Economic Policy Guidelines (BEPG) and Employment Guidelines (EG) (currently presented together as "integrated guidelines" but based on two distinct legal bases) should be merged into one single instrument expressing the Union's multiannual priorities, and crucially, that instrument should be adopted through the ordinary legislative procedure providing for co-decision by the European Parliament and the Council.
- (2) To be appropriately legitimised, a new power of requiring a revision of a national budget in line with European commitments, if considered necessary, could be taken as a legislative act by co-decision. This solution, ensuring maximum democratic legitimacy, is justified given that Member States' annual budgets are also adopted by their parliaments, usually with legislative character. To ensure speedy decision-making, a Treaty amendment should create a new special legislative procedure consisting of only one reading. Integration of the ESM into the EU framework, as called for in this blueprint, would allow it to become subject to proper scrutiny by the European Parliament.

The “blueprint” also suggests *institutional* adaptations:

A "*euro committee*" established within the European Parliament could also be granted certain special decision-making powers beyond those assigned to other committees, e.g. a greater weight in the preparatory parliamentary stages or even a possibility to perform certain functions or take certain acts in lieu of the plenary.

Within the *Commission*, any steps designed to reinforce even further than today the position of the Vice President for Economic and Monetary Affairs and the euro, would require adaptations to the collegiality principle and, hence, treaty changes. They could be contemplated in the long run to allow for political direction and enhanced democratic accountability of a structure akin to an EMU Treasury within the Commission. In this context, a special relationship of confidence and scrutiny between the Vice President for Economic and Monetary Affairs and a "*euro committee*" of the European Parliament could be created. Their design should however be carefully pondered. The collegiality principle applies to decisions across all policy areas for which the Commission has competence, from competition to cohesion policy. It stands for a system of collective internal checks and balances which contributes to improving the legitimacy of the Commission's action.

"Euro area Council": Sometimes a call is also made to strengthen the *Euro Group* further by making it responsible for decisions concerning the euro area and its Member States. This would require Treaty change, since the purely informal character of the Euro Group as set out in Protocol n° 14 implies a mere forum for discussions without decision-making powers. That said, the current Treaties, in Articles 136 and 138 TFEU, have already created the model of the Council adopting decisions with only its euro area members voting. In its "blueprint", the Commission makes the case for creating further Treaty legal bases following this model. The main practical difference between it, and a Euro Group endowed with decision-making powers, would be that, in the second case, delegates from non-euro area Member States would be excluded not only from voting but also from deliberations and from preparatory work carried out at instances below the ministers' meetings. That would however be undesirable in the Commission's view, since it would in reality lead to building up a *"euro area Council"* as a separate institution without adequately taking into account the convergence between existing and future members of the euro area.

ECB: Furthermore, a specific point to be addressed by Treaty change would be to strengthen democratic accountability over the ECB insofar as it acts as a banking supervisor, in particular by allowing normal budgetary control by the European Parliament over that activity. At the same time, Article 127 paragraph 6 TFEU could be amended to make the ordinary legislative procedure applicable and to eliminate some of the legal constraints it currently places on the design of the SSM (e.g. enshrine a direct and irrevocable opt-in by non-euro area Member States to the SSM, beyond the model of "close cooperation", grant non-euro area Member States participating in the SSM fully equal rights in the ECB's decision-making, and go even further in the internal separation of decision-making on monetary policy and on supervision).

ECJ: A further way of strengthening the EU's legitimacy would also be to extend the competences of the Court of Justice, i.e. by deleting Art. 126 paragraph 10 TFEU and thus admitting infringement proceedings for Member States or by creating new, special competences and procedures, although one should not forget that some of the issues do not lend themselves to full judicial review.

Mutualisation of debt burden: Finally, special challenges to ensure appropriate democratic accountability would arise in case the Treaty is changed to permit the mutualisation of the issuance of sovereign debt (*"Eurobills"*) underpinned by a joint and several guarantee of all euro area Member States. The underlying accountability problem is that such a joint and several guarantee, if claimed by creditors, may result in considerable financial burden for one individual Member State's finances, for which that Member State's parliament is accountable, although the

burden is the result of policy decisions that have been made over time by one or several other Member States under the responsibility of their parliaments. As long as the EU level is not granted very far-reaching powers to determine economic policy in the euro area and the European Parliament is not responsible for deciding on the resources of a substantial central budget either, this fundamental accountability problem cannot be overcome simply by entrusting the management of mutualised sovereign debt to an EU executive even if it is accountable to the European Parliament.

If the Treaty were changed so as to allow, as an intermediate step, the issuance of *short-term "Eurobills"*, combined with reinforced powers of economic governance, an accountability model resting both on the EU and national levels would have to be devised. A first step into the direction of Euro area bills are the so-called "Project bills" (already implemented in the MFF as an innovative financial instrument).

European Redemption Fund" (ERF): The proposal for an ERF raises accountability issues of a distinct nature. To design a model ensuring appropriate accountability for a ERF would presuppose that its legal basis can be framed with great legal precision, as regards the maximum transferrable debt, the maximum time of operation and all other features, to guarantee the legal certainty required under national constitutional laws.

4.2 The „Van Rompuy“ Plan for a genuine EMU

The proposal for a genuine EMU by Herman Van Rompuy Council, President of the European Council presented at the European Council meeting in December 2012 (see "Van Rompuy" plan, 2012) was the third attempt to improve the current political design of EMU. In many aspects the proposals resemble those of the "Barroso" plan. This is no surprise, because at the June 2012 European Council, the President of the European Council was invited "to develop, in close collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union".

The "Van Rompuy" plan also suggests a sequencing in three phases (see Figure 11):

Stage 1 (End 2012-2013): Ensuring fiscal sustainability and breaking the link between banks and sovereigns

This stage would include five essential elements:

- The completion and thorough implementation of a stronger framework for fiscal governance ('Six-Pack'; Treaty on Stability, Coordination and Governance; 'Two-Pack').

- Establishment of a framework for systematic *ex ante* coordination of major economic policy reforms, as envisaged in Article 11 of the Treaty on Stability Convergence and Governance (TSCG, 2012).
- The establishment of an effective Single Supervisory Mechanism (SSM) for the banking sector and the entry into force of the Capital Requirements Regulation and Directive (CRR/CRD IV).
- Agreement on the harmonisation of national resolution and deposit guarantee frameworks, ensuring appropriate funding from the financial industry.
- Setting up of the operational framework for direct bank recapitalisation through the European Stability Mechanism (ESM).

Some of these ambitious goals are already delayed (e.g. the establishment of the SSM is foreseen in 2014 and the CRD IV will also come into effect in 2014 at the earliest).

Stage 2 (2013-2014): Completing the integrated financial framework and promoting sound structural policies

This stage would consist of two essential elements:

- The completion of an integrated financial framework through the setting up of a common resolution authority and an appropriate backstop to ensure that bank resolution decisions are taken swiftly, impartially and in the best interest of all.
- The setting up of a mechanism for stronger coordination, convergence and *enforcement of structural policies* (a similar instrument as the CCI put forward in the “Barroso” plan) based on arrangements of a contractual nature between Member States and EU institutions on the policies countries commit to undertake and on their implementation. On a case-by-case basis, they could be supported with temporary, targeted and flexible financial support. As this financial support would be temporary in nature, it should be treated separately from the multiannual financial framework.

Stage 3 (post 2014): Improving the resilience of EMU through the creation of a shock-absorption function at the central level

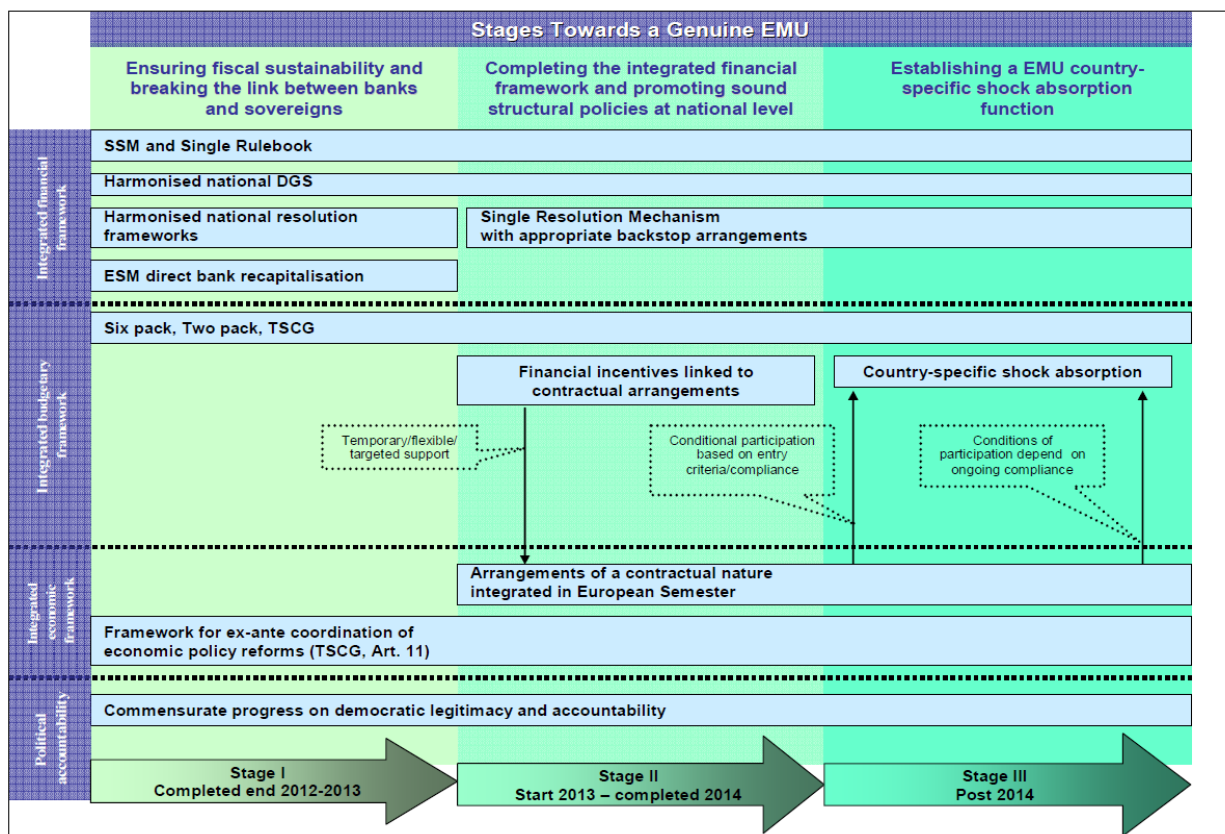
This stage would mark the culmination of the process. Stage 3 would consist in:

- Establishing a well-defined and limited “*fiscal capacity*” to improve the absorption of country-specific economic shocks (“*shock absorption function*” of an own Euro area budget), through an insurance system set up at the central level. This would improve the resilience of the euro area as a whole and would complement the contractual arrangements developed under Stage 2. A built-in incentives-based system would encourage euro area Member States eligible for participation in the shock absorption function to continue to pursue sound fiscal and structural policies in accordance with their contractual obligations. Thereby the two objectives

of asymmetric shock absorption and the promotion of sound economic policies would remain intrinsically linked, complementary and mutually reinforcing.

- This stage could also build on an increasing degree of common decision-making on national budgets and an enhanced coordination of economic policies, in particular in the field of taxation and employment, building on the Member States' National Job Plans. More generally, as the EMU evolves towards deeper integration, a number of other important issues will need to be further examined. In this respect, this report and the Commission's "Blueprint" offer a basis for debate.

Figure 11: The roadmap towards a genuine EMU of the “Van Rompuy” plan



Source: Van Rompuy (2012), Annex.

The “Van Rompuy” plan lastly wants integrated frameworks in three areas:

(1) *Integrated financial framework*: The establishment of a full European Banking Union with

the SSM a resolution mechanism and a deposit guarantee mechanism.

- (2) *Integrated budgetary framework*: In order to minimize spill-overs between Euro area countries (the Euro crisis has revealed the high level of interdependence) in times of crises sound national budgetary policy plus a financial capacity at Euro area level is necessary.
- (3) *Integrated economic policy framework*: A completed Single Market plus the Europe 2020 strategy should offer the major growth potential in the EU. Additionally the “Van Rompuy” plan proposes contractual arrangements to foster reforms in Euro area Member States.

Key elements of arrangements of a contractual nature on structural reforms:

- They would be embedded in the *European Semester*, be consistent with and support the overall euro area policy mix; they would be mandatory for euro area Member States but voluntary for the others, on the basis of thorough, on-the-ground reviews of the main bottlenecks of growth and employment. These reviews would be conducted by the Commission.
- They would cover a multiannual, specific and monitorable reform agenda jointly agreed with the EU institutions and focussed on competitiveness and growth that are crucial for the smooth functioning of the EMU.
- Member States and the Commission would be accountable, respectively, to national parliaments and the European Parliament on the content and implementation of their duties under the agreements.
- Structural reforms would be supported through financial incentives and would result in temporary transfers to Member States with excessive structural weaknesses. This targeted support should be financed through specific resources.
- Compliance with the agreements can be ensured by an incentive-based framework. Compliance could be one of the criteria for participating in the shock absorption function of the fiscal capacity. In addition, national contributions to the fiscal capacity could be increased in case of non-compliance.

A strong “*democratic legitimacy and accountability*” is advocated in both plans, in that of “Barroso” and also that of “Van Rompuy”³⁶.

However, the goals of both plans are political visions which have weak chances to be realized soon given the very EU critical mood in most European countries. Because both plans, that of “Barroso” and that of “Van Rompuy” are too ambitious and too far-reaching, the Heads of States or Government at the European Council meeting in December 2012 (European Council, 2012) only took note of these proposals, the realization according to the road maps of both proposals were, however, postponed. Only the establishment of the SSM was accepted as an important next step to stabilize the financial sector.

³⁶ Weidenfeld (2013) therefore pleads for a “civil union” or a “people’s Europe”.

4.3 The new role for the ECB – Lender of Last Resort?

The Euro crisis revealed a game with different speed between financial markets and the reactions by European politics. Whereas financial markets reacted very quickly politics (in a democratic policy setting) could follow only smoothly. While the policy is slow in responding to the crisis the ECB was the only EU institution which could respond quickly.

The ECB has taken part very actively in the Euro crisis management since 2010. Due to the legal constraint of Article 123 TFEU, however, the ECB cannot play the role as a “Lender of Last Resort” (LLR) for Member States of the Euro area³⁷. It can only play the role as “LLR for banks” or indirectly also for Member States insofar it buys sovereign bonds at the secondary market (ECB as the “Market Maker of Last Resort”; see De Grauwe, 2011B).

Step by step the ECB changed its monetary policy attitude from a traditional approach to a more unconventional one – similar to those of the FED after the GFC 2008/09. It started at the outbreak of the Euro crisis in May 2010 with a stabilization programme for the banking sector with the “Securities Markets Programmes” (SMP). This was followed by a further liquidity injection with the Longer-term Refinancing Operations (LTROs), starting in December 2011. The last coup was the announcement of the Outright Market Operations (OMTs) in September 2012.

ECB President Mario Draghi made a very important statement in his speech at the Global Investment Conference in London, 26 July 2012³⁸. More or less off the record he “dropped a bombshell”: “*Within our mandate, the ECB is ready to do whatever it takes to preserve the euro*”. “*And believe me, it will be enough*”. This was a strong signal to the financial markets to stop breaking up the Eurozone and to reduce speculations against periphery countries. This statement followed the announcement of the OMTs. Both actions were able to stabilize the upward trend in the spreads of sovereign bonds of the PIIGS. The interest rates of their bonds declined considerably since autumn 2012.

The Draghi statement as well as those of President Barroso (November 2011) and Chancellor Angela Merkel (August 2012) to do whatever they can to keep the Euro area in its present dimension of 17 Member States, helped to reduce the probability of a breaking-up of the Eurozone, which were considerably high in the first half of 2012.

³⁷ Therefore the ECB is not allowed to participate in actions of a direct “haircut” of sovereign bonds of Euro area Member States, like in the case of the private (PSI) “haircut” in the Greece I and II rescue packages (see Table 2). For a discussion, see also FAZ (2012) and Neue Zürcher Zeitung (2012A).

³⁸ See the ECB website: <http://www.ecb.int/press/key/date/2012/html/sp120726.en.html>

Standard measures – Key interest rates

Since the GFC 2008/09 central banks around the world reduced their key interest rates step by step to historical low levels. The *Fed* stepped down with its key interest rate (the Federal Funds Rate – FFR) from the pre-crisis high of 5.25% on 18 September 2007 to 4.75% and then down to 0% to 0.25% on 16 December 2008. Since then the FFR remained at this low level. According to Fed President Ben Bernanke the Fed will keep these rock-bottom interest rates through to 2015 and beyond. The Fed’s Federal Open Market Committee (FOMC) said it will remain in super-stimuli mode “at least as long” as the unemployment rate remains above 6.5% and inflation is projected to be below 2.5%.

The *ECB*, in a somewhat delayed reaction to the GFC 2008/09 started to reduce its high key interest rate (Main refinancing operation rate – MROR) from the high level of 4.25% on 8 October 2008 down firstly to 3.75% and then step by step to the historic low level of 0.75% on 5 July 2012. Since then the MROR and the other rates (Marginal lending facility – 1.5%; and Deposit facility - 0%) remained at this low levels.

Non-standard monetary policy measures

“Quantitative easing (QE)” is an unconventional monetary policy used by central banks to stimulate the national economy when conventional monetary policy has become ineffective because the key interest rate is already near at zero level. In case of QE the central bank buys bonds from the private or public sector in order to ensure liquidity. In this case the active part of the central bank balance sheet increases. Base money is created by a QE policy and the fear of inflation can arise if the additional money creation is not sterilized properly.

The first central bank applying QE was the *Bank of Japan* in March 2001. After the GFC 2008/09 other central banks (as of March 2009), the *Bank of England* and the *Fed* (firstly this policy was called “credit easing”) started with QE. A new programme, “Quantitative easing II” (QE2) has been started by Fed’s FOMC on 3 November 2010 and ended in June 2011. A QE3 was announced in September 2012. As an intermediate instrument the Fed used a policy of “Operation Twist” (which was already used in 1961) by which the Fed sells US Treasuries with short-term maturity (less than 3 years) amounting to 400 bn USD³⁹.

In any case the balance sheets increased dramatically in all important central banks (Fed, Bank of England, Swiss National Bank and ECB – although its unconventional policy was not a QE)⁴⁰. The US Federal Reserve held between \$700 billion and \$800 billion of Treasury notes on its

³⁹ The change in the monetary policy attitude of many central banks after the GFC 2008/09 can be criticised as to target “too many goals” (see Herz, 2013) - from inflation targeting to “nominal GDP targeting” – and the danger of losing its strict independence from politics (e.g. in Japan).

⁴⁰ See more in Wikipedia „Quantitative easing”: http://en.wikipedia.org/wiki/Quantitative_easing

balance sheet before the recession. In late November 2008, the Fed started buying \$600 billion in Mortgage-backed securities (MBS). By March 2009, it held \$1.75 trillion of bank debt, MBS, and Treasury notes, and reached a peak of \$2.1 trillion in June 2010. Further purchases were halted as the economy had started to improve, but resumed in August 2010 when the Fed decided the economy was not growing robustly. After the halt in June holdings started falling naturally as debt matured and were projected to fall to \$1.7 trillion by 2012. The Fed's revised goal became to keep holdings at the \$2.054 trillion level. To maintain that level, the Fed bought \$30 billion in 2–10-year Treasury notes a month. In November 2010, the Fed announced a second round of quantitative easing, or "QE2", buying \$600 billion of Treasury securities by the end of the second quarter of 2011. A third round of quantitative easing, or "QE3," was announced by the Federal Reserve in September 2012. The third round includes a plan to purchase US\$40 billion of mortgage-backed securities (MBS) per month. Additionally, the Federal Open Market Committee (FOMC) announced that it would likely maintain the federal funds rate near zero "at least through 2015."

The *ECB* – in contrast – did not follow a QE policy but called its monetary policy in a situation of extremely low key interest rates, "*non-standard measures*"⁴¹:

Since the intensification of the financial crisis in September 2008 (after the collapse of Lehman Brothers the inter-banking market collapsed too), and against the background of rapidly receding inflationary pressures, the ECB has introduced a number of non-standard monetary policy measures that are unprecedented in nature, scope and magnitude with the aim to safeguard an appropriate monetary policy transmission mechanism⁴²:

- ECS: Enhanced Credit Support (since October 2008);
- SMP: Securities Markets Programme (since May 2010);
- LTRO: Longer-term Refinancing Operations (since December 2011), and;
- OMT: Outright Monetary Transactions (announced September 2012).

ECB's non-standard monetary policy measures are directed to ensure enhanced access of the banking sector to liquidity and facilitate the functioning of the Euro area money market. They are expected to support the provision of credit to households and non-financial corporations, hence to avoid or mitigate a possible "credit squeeze".

⁴¹ See the ECB website "Monetary policy decisions":

<http://www.ecb.europa.eu/mopo/decisions/html/index.en.html>

⁴² For a "Chronology of Monetary Policy Measures of the Eurosystem", see ECB (2012).

ECS

In addition to the reduction in interest rates, on 7 May 2009 the Governing Council also decided to proceed with its “Enhanced credit support” (ECS). In line with the operations undertaken since October 2008, and in recognition of the central role played by the banking system in financing the euro area economy, the Eurosystem conducted liquidity-providing longer-term refinancing operations with a maturity of 12 months via fixed rate tender procedures with full allotment. Furthermore, the Governing Council decided that the European Investment Bank (EIB) will become an eligible counterparty in the Eurosystem’s monetary policy operations with effect from 8 July 2009 and under the same conditions as any other counterparty. Finally, the Governing Council decided in principle that the Eurosystem will purchase euro-denominated covered bonds issued in the euro area.

SMP

In two waves of “Securities Markets Programmes” (SMP) the ECB has engaged in buying sovereign bonds. The first SMP started in May 2010 as a reaction to the Greek crisis. This programme ended in March 2011. Up to August 2011 the ECB has bought sovereign bonds of Euro zone countries (mainly from Greece, Ireland and Portugal) amounting to €74 bn. Due to the danger of contagion towards Italy and Spain the ECB started with a second SMP on 7 August 2011⁴³. This time the ECB bought Italian and Spanish sovereign bonds. With the announcement of the OMTs on 2 September 2012 the SMP has been terminated.

LTRO

On 8 December 2011 the ECB Governing Council made the following decisions:

First, it started with two Longer-term Refinancing Operations (LTROs)⁴⁴ with a maturity of 36 months and the option of early repayment after one year. The operation has been conducted as fixed rate tender procedures with full allotment. The rate in these operations was fixed at the average rate of the main refinancing operations (around 1%) over the life of the respective operation. Interest will be paid when the respective operation matures. The first operation has been allotted on 21 December 2011 and will replace the 12-month LTRO announced on 6 October 2011. Around €489.2 billion of three-year loans were advanced to euro-zone banks in this first wave of 3 yrs liquidity auction. The second auction took place on 1 March 2012 with a

⁴³ See ECB Press Release: Statement by the President of the ECB:
<http://www.ecb.europa.eu/press/pr/date/2011/html/pr110807.en.html>

⁴⁴ See the “Introductory statement to the press conference by Mario Draghi, President of the ECB, Frankfurt am Main, 8 December 2011”: <http://www.ecb.europa.eu/press/pressconf/2011/html/is111208.en.html>

volume of €529.5⁴⁵.

The LTRO intended to increase collateral availability by reducing the rating threshold for certain asset-backed securities (ABS). In addition to the ABS that are already eligible for Eurosystem operations, ABS having a second best rating of at least “single A” in the Eurosystem harmonised credit scale at issuance, and at all times subsequently, and the underlying assets of which comprise residential mortgages and loans to small and medium-sized enterprises, will be eligible for use as collateral in Eurosystem credit operations. Moreover, national central banks will be allowed, as a temporary solution, to accept as collateral additional performing credit claims (namely bank loans) that satisfy specific eligibility criteria. The responsibility entailed in the acceptance of such credit claims will be borne by the national central bank authorising their use. These measures will take effect as soon as the relevant legal acts have been published. This “loosening” the conditions for collaterals has been criticized (see *Neue Zürcher Zeitung*, 2012B)

Second: The ECB has reduced the reserve ratio, which is currently 2%, to 1%. This will free up collateral and support money market activity. As a consequence of the full allotment policy applied in the ECB’s main refinancing operations and the way banks are using this option, the system of reserve requirements is not needed to the same extent as under normal circumstances to steer money market conditions. This measure took effect as of the maintenance period starting on 18 January 2012.

Early in 2013 many European banks announced that they will repay their money they got from the ECB in the context of the LTROs.

OMT

Following the Euro area stabilizing statement by President Mario Draghi in London, July 2012, the ECB announced a new programme, called Outright Monetary Transactions (OMTs). As announced on 2 August 2012, the Governing Council of the European Central Bank (ECB), on 6 September 2012⁴⁶ has taken decisions on a number of technical features regarding the Eurosystem’s outright transactions (purchase) of sovereign bonds at an unlimited basis (!) on the secondary sovereign bond markets that aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy. The Outright Monetary Transactions (OMTs) will be conducted within the following framework:

Conditionality:

A necessary condition for OMTs is strict and effective conditionality attached to an appropriate ESM programme. Such programmes can take the form of a full ESM macroeconomic adjustment

⁴⁵ See the ECB Website “Open market operations”:

<http://www.ecb.europa.eu/mopo/implementation/omo/html/index.en.html>

⁴⁶ See ECB Press Release 6 September 2012: “Technical features of OMTs”

http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of ESM primary market purchases. The involvement of the IMF shall also be sought for the design of the country-specific conditionality and the monitoring of such a programme. The Governing Council will consider OMTs to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected, and terminate them once their objectives are achieved or when there is non-compliance with the macroeconomic adjustment or precautionary programme.

Via the conditionality of OMTs and ESM there is – for the first time in EMU – the opportunity to engage in a *full cooperation/co-ordination between monetary and fiscal policy* to derive the optimal gains from cooperation/co-ordination as forecast in many game-theoretic analyses in the literature (for an overview, see: Breuss, 2006, pp. 543 ff.). Hitherto there was only a “Political Dialogue” between both policy areas (see Figure 1).

Coverage:

OMTs will be considered for future cases of ESM macroeconomic adjustment programmes or precautionary programmes as specified above. They may also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access. Transactions will be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between one and three years. No ex ante quantitative limits are set on the size of OMTs.

Creditor treatment:

The Eurosystem intends to clarify in the legal act concerning OMTs that it accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through OMTs, in accordance with the terms of such bonds.

Sterilisation:

The liquidity created through OMTs will be fully sterilised.

Transparency:

Aggregate OMT holdings and their market values will be published on a weekly basis. Publication of the average duration of OMT holdings and the breakdown by country will take place on a monthly basis.

Securities Markets Programme:

With the decision on Outright Monetary Transactions, the Securities Markets Programme (SMP) has been terminated. The liquidity injected through the SMP will continue to be absorbed as in the past, and the existing securities in the SMP portfolio will be held to maturity.

The effect of the mere announcement of the OMTs, to purchase sovereign bonds (primarily of the PIIGS) had enormous implications on the financial markets:

The formerly exploding spreads of the PIIGS bonds suddenly were reduced to normal risk-





indicating levels in Greece, Ireland, Italy⁴⁷, Portugal and Spain. Some of the PIIGS were already able to issue new bonds on the markets.

The bets on the breakup of the Euro zone, which were quite high in the first half of 2012, dwarfed to low levels. It seems as if the commitments by Barroso, Merkel and by Draghi to keep the Eurozone together were fundamental for the coherence of the Euro zone during 2012. Seen from the financial markets perspective Mr. Draghi became the rescuer of the Euro zone.

5. FOUR SCENARIOS FOR THE FUTURE OF THE EURO

McKinsey Germany (2012, pp. 16-23) has attempted to look into the future of the Eurozone. The economic perspectives of the Eurozone are analysed under four possible scenarios to overcome the current crisis (see Table 3). The possible economic impact is demonstrated by the use of macromodel simulations (see Figure 12).

Table 3: Four possible scenarios for the future of the Euro

	Monetary bridging	<ul style="list-style-type: none"> ▪ Continued reactive crisis management, incl. <ul style="list-style-type: none"> – Liquidity support packages (e.g., EFSF, ESM) – Potentially expanded ECB involvement 	<i>Focus only on liquidity (buying time, no long-term solution)</i>
	Fiscal pact plus	<ul style="list-style-type: none"> ▪ EMU economic government coordination with emphasis on strict austerity measures ▪ IMF-style monetary support and economic programmes to support structural changes 	<i>Focus on</i> <ul style="list-style-type: none"> ▪ Structural reforms ▪ Liquidity provision ▪ Debt reduction
	Closer fiscal union	<ul style="list-style-type: none"> ▪ EMU economic government as long-term target ▪ Increased fiscal transfers and taxation on EMU level potentially with jointly issued eurobonds 	<i>As in the fiscal pact plus scenario, but focus on integration of fiscal policies (incl. transfers)</i>
	Northern euro/euro break-up	<ul style="list-style-type: none"> ▪ GIIPS countries leave EMU ▪ Remaining countries adhere to a strict Stability and Growth Pact and form new "Northern euro" 	<ul style="list-style-type: none"> ▪ Large short- to medium-term costs ▪ Potentially severe social consequences

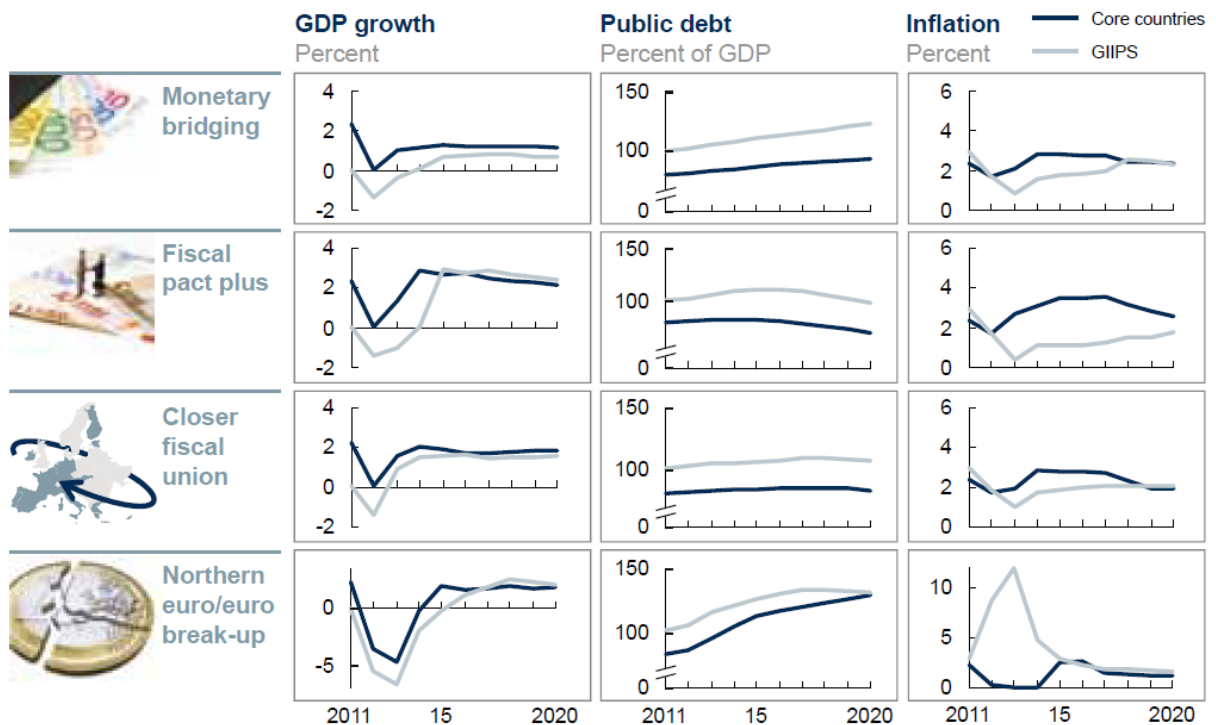
Source: McKinsey (2012), p. 16

⁴⁷ The parliamentary elections in Italy (24/25 February 2013) with its indecisive outcome, however, ignited additional insecurities in the financial markets and could lead to a renewed inflammation of the Euro crisis.

5.1 Scenario 1: Monetary bridging – status quo

In this scenario the existing agreements are implemented only partially. The crisis management is only reactive and addresses ad hoc liquidity problems and budgetary deficits. It is only oriented on short-term solutions. This scenario assumes that EU politicians do not focus on long-term fiscal stability or on restoring competitiveness and growth. The interventions of the EFSF and ESM will not be sufficient to reassure financial markets, and this would force the ECB to increase its intervention to stabilise markets, a position in which the ECB acts at the limits of legal justification according to Article 123 TFEU.

Figure 12: Macroeconomic consequences of the four euro scenarios



Source: McKinsey (2012), p. 17

The macroeconomic implications can be found in Figure 12. Eurozone GDP growth would be weak, with average annual growth of 0.6 percent from 2011 to 2016. Debt levels would increase

to an average of 89 percent of GDP in 2016 in the *core countries* (EUR-17 minus 5 GIIPS; primarily consisting of the old DM bloc) and to an average of 113 percent in the *GIIPS* (Greece, Italy, Ireland; Portugal, and Spain) countries. Unemployment in the Eurozone would increase to 11.4 percent in 2016. In any case, GDP of the GIIPS countries would develop at a slower rate than those of the core countries of the Eurozone.

5.2 Scenario 2: Fiscal pact plus

This scenario assumes the full implementation of the policy proposals (“new economic governance” of EMU) that focused on the reform of the SGP-III (“Six-Pack”) and the so-called “Fiscal stability union” with the “Fiscal Pact” (see TSCG, 2012). This includes strict limits on budget deficits and proposals for strict enforcement for the Eurozone. Countries are expected to observe a limit on cyclically adjusted deficits of 0.5 percent of GDP and to introduce constitutional debt brakes. Each country remains responsible for its own budget.

Drawing lessons from Nordic countries (Finland and Sweden) this scenario involves the promotion of policy coordination (develop the initiated EMU economic governance), the provision of liquidity (developing the EFSF/ESM mechanism into a full European Monetary Fund (EMF) and relying further on IMF support), and a long-term growth agenda based on structural reforms (flexibility of real wages, labour mobility; restructuring the banking sector; a new version of the Marshall Plan or simply the full implementation of the “Europe 2020” agenda).

This scenario would address the entire spectrum of essential issues. In particular, it would combine short-term liquidity provision and efforts to produce long-term sustainability that would allow the Eurozone to outgrow the current debt crisis. Growth in the near term would be weak, in particular in the GIIPS countries which adopt austerity measures. The annual average GDP growth from 2011 to 2016 could reach 1.5 percent in the Eurozone, with only 0.7 percent in the GIIPS countries and 1.9 percent in the other core Eurozone countries. In the medium to long term higher growth than in any other scenario can be expected, with an annual average growth rate of close to 2 percent in all Eurozone countries between 2011 and 2021. Overall debt levels would peak at 89 percent of GDP by 2016, and unemployment would be at around 11 percent in 2016 after a peak of 12.6 percent in 2014.

5.3 Scenario 3: Closer Fiscal Union and “Fiscal Transfer Union”

A monetary union functions properly when it follows the basic principle “*one country, one money*”. The EMU of the European Union, however, tries to run on the principle “*one market, one money*”. In “fair weather” periods this may work quite well (as it did with the asymmetric

policy design – centralized monetary, decentralized fiscal policy - of the EMU during 1999 to 2007), in times of severe shocks like the global financial crisis in 2008/09 and the following sovereign debt crisis in the Eurozone, such a construct cannot work. EMU must therefore be complemented with a fiscal union and lastly with a Political Union. Eurozone member states must concede some of their fiscal sovereignty.

In this scenario the degree of fiscal integration would be much greater than that of scenario 2 (fiscal pact plus). One can imagine, over different time horizons, a deeper economic integration (creation of a real “economic union”, not only a “monetary union”), with an enlarged degree of joint “EU economic government” with a centralized EU budget (“European finance minister”), elements of EMU-level taxation, the issue of Euro Bonds, and a move towards more “fiscal federalism”, including higher permanent transfer payments. Lastly this scenario of a “closer fiscal union” transforms into a “Fiscal Transfer Union”. The redistribution mechanism of the Eurozone would evolve from only temporary transfers (based on an insurance-based fiscal transfers scheme to support the adjustment process – via structural funds, funds to deal with banking crises vis a true “Banking Union” etc.) to permanent ones. (The increased Eurozone budget could act as an automatic stabiliser and effectively recycles tax revenues like in the system of “fiscal federalism” in the United States).

The “Fiscal Transfer Union” scenario would be slightly less positive for the Eurozone economy than scenario 2 (fiscal pact plus). Overall average annual growth rate between 2011 and 2016 would be around 1.3 percent but only 0.8 percent in the GIIPS countries. Debt levels would reach 91 percent of GDP in 2016 for the Eurozone as a whole compared with 80 percent in 2010 and 89 percent in scenario 2. With a projected level of 11.3 percent unemployment levels in 2016 would be similar to those in scenario 2 but still higher than the 10.1 percent of 2010.

5.4 Scenario 4: Northern euro/euro break-ups

In this scenario of a break-up of the EMU, the struggling economies (GIIPS) are closed off from access to funds (EFSF/ESM) and therefore forced to leave. Those countries that remain form a Northern euro – the “N-Euro”. McKinsey assumes that this would include Germany, France, Luxembourg, Belgium, Austria, Finland, the Netherlands, Estonia, Slovakia, and Slovenia. The N-Eurozone would strengthen the SGP-III with debt brakes codified in members’ constitutions, and violations would be identified by independent authorities such as Eurostat or others. Sanctions would be implemented automatically and legally enforced by the European Court of Justice. Also codified into constitutions would be a no-bailout rule (like the one in Article 125 TFEU). A mechanism would deal with macroeconomic imbalances (like the one in the “Six-Pack”) between member states, although the N-Euro zone would consist of much more economically homogenous countries than today’s Euro zone of 17 member states.

This scenario would come at prohibitive costs, not least because of the pronounced interdependence of the assets and liabilities. European governments would have to bail-out and rescue the damaged financial sector. Also in the non-financial corporate sectors, the break-up of the Euro zone would lead to lost opportunities at the microeconomic level (e.g. less chance to utilize the full capacity of economies of scale of a large – EU Single market).

This scenario has the most negative effect on Eurozone growth. The break-up would involve a depreciation in the GIIPS vis à vis the countries of the North (of approximately 30 percent on average of the new GIIPS currencies), and it would be followed by a severe recession, with GDP falling by more than what was witnessed during the great recession of 2008 and 2009. Average annual growth rate for N-Euro countries between 2011 and 2016 would be minus 0.9 percent, with a severe recession in 2012 and 2013. Average annual growth in GIIPS countries between 2011 and 2016 would be minus 2.7 percent, with a severe recession lasting until 2015. Government debt in 2016 would be an estimated 110 percent of GDP compared with 80 percent in 2010 for N-Euro countries but 129 percent of GDP for GIIPS countries compared with 98 percent in 2010. The unemployment rate would reach unprecedented highs in GIIPS countries at around 24 percent compared with 13.4 percent in 2010. This scenario would also cause a liquidity crisis similar to or worse than the one in the wake of the Lehman bankruptcy. Due to the high depreciation in the GIIPS countries their inflation rate would jump to over 10 percent in the short-run.

Box III: From “Grexit” to “Brexit”?

“Grexit”

After more than two years of struggling with stabilizing the Greek sovereign debt crisis the Euro area partners get nervous. The second Greek rescue package (€130 bn aid plus 50% “haircut” by banks (PSI)) released in tranches since March 2012 and the additional measures in December 2012 (see Table 2) may not be enough to lead to a sustainable path of debt development in Greece. Therefore, partly from the political side, partly from academic circles the risks/costs of Greek Euro Area Exit (called “Grexit” by Buiter-Rahbari, 2012) has been discussed. There is no clear-cut answer what would be exactly the costs for Greece when returning to the Drachme and devaluating it by 50 or more percent; although the risks and consequences of the Euro area partners are uncertain (risk of contagion; uncontrolled insolvency with implications to banks, governments and National and ECB holding Greek sovereign bonds). An early UBS study on the “Grexit” scenario came to very dramatic costs (see Deo-Donvan-Hatheway, 2011), Other studies by Buiter-Rahbari (2012) firstly increased the probability of a “Grexit” to 50% from 25% to 30% earlier (Buiter-Rahbari, 2011; Buiter, 2011) and they found that the Euro area is now better

prepared to challenge a “Grexit”. The EU Treaty does not (yet) allow only the exit of a member state from the Euro zone, only the exit from the EU (Article 50 TFEU; see Athanassiou, 2009). So practically a “Grexit” could only be exercised by an exit from the EU which entails an exit from the EMU and later on a re-entry into the EU’s single market (see Bagus, 2011; Neue Zürcher Zeitung, 2012C)⁴⁸.

Due to the commitments of major European leaders (Barroso, Merkel and Draghi), however, the probability of a break-up of the Eurozone as well as a “Grexit” has decreased dramatically. Consequently, since autumn 2012, such “thought experiments” practically vanished.

“Brexit” or “Brixit”

After the speech of Prime Minister David Cameron on 23 January 2013 the probability of an EU exit of Great Britain (“Brexit”) increased considerably and displaced the possible of a “Grexit”. Cameron announced an “in-out” referendum on Britain’s membership of the EU by 2017.

In mid-2012, the terms “Brexit” and “Brixit” were coined for the concept of the United Kingdom ceasing to be member of the EU. The Centre for European Reform has been credited with the invention of the term “Brexit” (though it was previously used by “The British Resistance”. The term “Brexit was coined by the Economist columnist Bagehot in the article “A Brixit looms”, dated 21 June 2012⁴⁹. Already, in a 1975 referendum, the United Kingdom voted to stay in its precursor the European Economic Community (EEC), after having joined in 1973.

The debate about the possible political and economic costs and benefits for the UK and for the Rest-EU in case of a “Brexit” just started (see the conference of Policy Network, 2013). An earlier evaluation by Hindley and Howe (2001) sees only marginal negative effects for the UK (see the other opinions, in Laczynski, 2013).

6. CONCLUSIONS

The Eurozone appears to have entered a moment of calm, defying the hyperbole and doom saying of recent times. Nevertheless, controversial debates rage on as to whether the crisis is actually dissipating or simply at an interval. At the same time, new strategic questions about the future shape and direction of the European Union and the Economic and Monetary Union (EMU) in

⁴⁸ Several authors studied and quantified the possible impact of a “Grexit” or the break-up of the Euro zone (see Bootle, 2012; Breuss, 2012A based on Oxford Economics). The macroeconomic implications are grim for Greece (or any other country leaving the Euro zone) and also not negligible for the remaining Member States of the Euro zone.

⁴⁹ See “*United Kingdom withdrawal from the European Union*”, in Wikipedia:
http://en.wikipedia.org/wiki/United_Kingdom_withdrawal_from_the_European_Union

particular, have emerged, which pose significant political dilemmas for European leaders. If anyone needed reminding of this, David Cameron's thinly veiled challenge to the 'remorseless logic' of further integration provided it.

This study tried to retrace the developments within the EU and the Eurozone since the outbreak of the GFC 2008/09 and the following “Euro crisis” in 2010. Since then we witness an enormous overhauling of the governance structure of EMU. In many institutional, political and legal fields the crisis has speeded up the necessary reforms to make the Eurozone crisis-proof in the future. However, in reaction to the crisis there are two tendencies: Due to the specific crisis management concerning primarily the PIIGS within the Eurozone there is a tendency towards “more Europes”, i.e. a multiple separation of the EU into Euro area members and non-members. Furthermore, within the Euro area we see a split between North and South, between donors (North) and donees (South or periphery). In contrast, all the new proposals to form an “genuine” and new EMU point in the direction of “more Europe”, meaning a transfer of power and competences from the member states to the EU/Euro area level.

Besides the already implemented measures of new economic governance (“Six-Pack”, “Two-Pack”, “Fiscal Pact”), the rescue instruments (EFSF/ESM) and the surveillance authorities in the financial markets the EU/Euro area being already a “Transfer Union” is on the way to a “Fiscal Union” and together with a “Banking Union” and a “Single Market Plus” will become an “Economic Union”. The last step foreseen already in the plans by Barroso and Van Rompuy will be a “Political Union”. Until we get there, we have to convince the public of the benefits of the European Union.

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