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Crisis Management in the Euro Area: Why Europe's Policy is on the Right Track

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The aim of this article is to show that the crisis-driven pragmatism of politics is an appropriate way of resolving the problems in the currency area and placing the European Economic and Monetary Union (EMU) on a new, more stable footing. On the other hand, the proposals on economic policy emanating from the extreme poles in this debate – the "integrationists" and the "minimalists" – do not appear to offer practical solutions to the crisis because they either imply illusory political circumstances or puristically hold firm to a failed construct. This paper will show that the policies that have been agreed at the heart of the Fiscal Compact and the Stability and Growth Pact, along with the establishment of the EFSF and ESM stability mechanisms and the planned banking union, are appropriate ways of addressing the structural defects in the EMU.

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CONTENTS

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1. INTRODUCTION

The hypothesis of this article[1] is that Europe's policy is on the right track when it comes to finding a lasting solution to the crisis in the European Economic and Monetary Union (EMU). This might sound surprising in view of the predominantly negative reaction on the part of some economists to the political pragmatism that has resulted from the crisis. Two main directions can be distinguished in the current debate on potential ways out of the crisis. On the one side are the "integrationists", who believe the solution to the crisis lies in the partial or total mutualisation of sovereign debt, while on the other side are the "minimalists", who insist that the EU should return to the Treaties of Maastricht and Lisbon and enforce the unconditional "no bail-out" clause.

We believe that both these positions are fundamentally unsuited to resolving the crisis in the long term. The proposals on economic policy put forward by the "integrationists" that involve intervention in national budget laws presuppose a level of political integration within the EMU that is not on the agenda of European politics and that in any case could not be achieved in the short term. Yet without such a level of integration, any kind of mutualisation of sovereign debt would suffer from a lack of democracy and encourage the moral hazard of unstable fiscal policies.

The "minimalists", on the other hand, misjudge the previous structural weaknesses in the EMU that laid the foundations for the crisis. Without removing these weaknesses, the EMU will be unable to return to a lasting and stable equilibrium and will be in even greater danger of collapse. These weaknesses include:

- the inadequate implementation mechanism for sound economic and fiscal policies;
- the divergence in economic growth since the start of the monetary union;
- the monetary union's distortion of risk ratings in capital markets and
- the channels of contagion between states and banks.

However, in contrast, the policy-driven structural reforms to the EMU – at the heart there is the Fiscal Compact and the Stability and Growth Pact, the establishment of the EFSF and ESM stability mechanisms and the planned banking union – contain an appropriate combination of joint guarantees ("firewalls") and subsidiarity ("no bail-out" clause) on the one hand with national, democratically legitimised sovereignty ("budget law") and necessary European integration ("banking union") on the other, in order to create a new and lasting equilibrium within the EMU.

This article is structured as follows: based on the optimum currency area theory, first of all the structural weaknesses of the EMU will be investigated and both poles of the academic debate will be put under the critical microscope. We will then show how European policies can change the institutional frameworks in such a way that the EMU can be guided towards a new and stable equilibrium. The monetary policy of the ECB will not be specifically discussed. However, the conclusion will show that monetary policy would once again be in a position to return to its original mandate as a significant side effect of this new equilibrium.

2. STRUCTURAL WEAKNESSES OF THE EMU

The assertion that the EMU is not an optimum currency area according to the optimum currency area theory propounded by Mundell (1961), McKinnon (1963) and Kenen (1969) has become a truism of economic research since the publication of the Delors Report in 1989 (Bayoumi, T. and Eichengreen, B. 1993, p. 193 f.). Based on this theory, the effects of the global financial crisis of 2008 on the EMU should have been easy to foresee. The wave of bank crashes and the general collapse in demand had an asymmetrical shock on the EMU. Wage and price rigidity combined with the low mobility of the labour factor of production has hampered the economic adjustment processes that were necessary in light of the structural and economic heterogeneity of the EMU states in order to compensate for the shortfalls in national exchange rate and interest rate mechanisms. The most concise expression of this heterogeneity is the divergence in labour unit costs and corresponding national inflation rates and current account balances since the start of the monetary union (ECB 2012b, p. 64 f.; Bundesbank 2012a, p. 18 f.). After the crisis erupted, the capital markets carried out a dramatic reassessment of country risks, a process which is still under way.

The launch of the monetary union in a non-optimum currency area was justified in economic debates by the "triangle argument" (Mongelli, F. P. 2002, p. 10). This states that monetary integration drives economic integration and hence political integration. A second approach is the "endogeneity approach" of Frankel und Rose (1997, 1998). This approach is based on the hypothesis that the establishment of a non-optimum currency area can ex post under certain conditions lead to an optimum currency area. This is substantiated with the endogeneity of increasing trade integration and the convergence of economic cycles and income into a monetary union (De Grauwe und Mongelli, F. P. 2005, p. 25; Baumann S. and Löchel, H. 2006, p. 10 f.).

In the light of experience, both these hypotheses must be considered as being disproven. The monetary union has not helped to drive forward economic or political integration in Europe to the expected degree. However, on the monetary union's credit side, it has achieved low average rates of inflation in the euro area, the partial integration of the European financial markets and the positioning of the euro as the second international currency after the US dollar (Becker 2012, p. 9).

The monetary union began with an interest rate shock (Lane, P. R. 2006, p. 3). Interest rate convergence combined with relatively high inflation rates led to historically low or even negative real interest rates in the southern countries of the monetary union. This was because capital from the core countries of the EMU flowed out to the "peripheral countries" and in turn this heightened the differences in the processes of economic adjustment.

In terms of economic policy, the Treaty of Maastricht set out an incentive mechanism for its convergence criteria that was only valid until a Member State joined the EMU. After that, studies of the euro area countries show that the desire to reform began to dwindle (Duval, R. u. Elmeskov, J. 2005, p. 35) and identify major fiscal free-rider problems as a result of the weak disciplining effect of the financial markets on national fiscal policies (Fratzscher, M. and Stracca, L. 2009, p. 339).

Running counter to the predictions of the endogeneity approach, the introduction of the euro has also not contributed to a strengthening of the existing historical trend of increased internal trade within the EMU (Berger, H. and Nitsch, V. 2005, p. 24; Lane, P. R. 2006, p. 11). The only things that have in fact intensified are the integration of the financial markets and portfolio investments in the euro area. The theory that there would be a convergence of economic cycles and income has also not been verified.

3. A RETURN TO MAASTRICHT?

The creation of the Treaty of Maastricht in conjunction with the Stability and Growth Pact was unable to compensate for the lack of an optimum currency area. The no bail-out clause in particular proved impossible to sustain. The reasons for this can be explained in terms of institutional theory, game theory or capital market theory.

In terms of institutional theory, the focus is on the fact that the predominantly inter-governmental governance approach that the individual Member States are supposed to use to supervise the provisions of the monetary union has misfired because it leads to a classic conflict of interests by expecting the monitors to monitor themselves (Beetsma, R. and Giuliodori, M. 2010, p. 627). The blocking of the Stability and Growth Pact by Germany and France in 2003 was the most telling example of this conflict (Bergsten, C. F. and Kirkegaard, J. F. 2012, p. 4).

In terms of game theory, it can be argued that both "strong" and "weak" euro area states have an incentive to break the no bail-out clause (Straubhaar, T. and Vöpel, H. 2012, pp. 59-62). Over-indebted states have an incentive to externalise portions of their debt to other members of the EMU, while "healthy" members have an interest in holding the monetary union together because of fears of contagion and to gain economic advantages.

In terms of capital market theory, a monetary union is based on the unique situation that the Member States can no longer pay off their debts in the currency that they control (De Grauwe, P. 2011, p. 8; Sachverständigenrat (German Council of Economic Experts) 2011, p. 136). This invites the capital markets, which tend to focus on the short term, to either play down the specific country risks – as happened between 1999 and 2008 – or to exaggerate them, as has been the case since the debt crisis began in 2010.

In light of these weaknesses it cannot simply be a case of a "return to Maastricht" and to the "no bail-out" clause. The capital markets obviously decided this clause was simply not credible. The first few years of the EMU have made it abundantly clear that a stable monetary union not only has to include a practical and hence credible mechanism for controlling the public purse, but it also has to join together to face up to the upheavals in the financial sector. The *Bundesbank* recently once again called for "responsible economic and financial policies" (2012b, p. 28), but these require the basic conditions to be changed without being obliged to abandon the principle of subsidiarity.

In June 2012 the President of the European Council presented a strategy paper that proposed a different route, namely the mutualisation of sovereign debt (Van Rompuy, H. 2012, pp. 5-6). This proposal has long enjoyed widespread support from academics and has had an effect on various issues such as Eurobonds and the joint redemption fund of the German Council of Economic Experts (2012).

The fundamental flaw in these proposals is not so much their lack of compatibility with incentives, as the mutualisation of debts would also involve the vetting of national budgets, but rather the illusion of abandoning national sovereignty, which is essential for any kind of mutualisation. And so far it is not at all clear whether and how the idea of the democratic sovereignty of the nation state and its fiscal laws can be carried over to a supranational European level (Habermas, J. 2011, p. 39 f). Forcing through a "European Political

Union" as a result of the crisis would mean that the EMU was clearly overstepping its mandate. Creating such a union falls in the remit of politicians and the citizens of Europe themselves.

In view of the weaknesses of the existing academic proposals on economic policy, we would now like to explain our theory that the crisis-driven pragmatism of European politics has brought about a combination of measures that seem to be appropriate for dealing with the crisis and ensuring the future stability of the EMU. This can happen without the need for the mutualisation of sovereign debt, but it has to go beyond the Treaties of Maastricht and Lisbon (Fuest, C. 2012, p. 30).

4. POLITICAL PRAGMATISM

Since 2010 the EU summits have set in motion a whole series of fundamental reforms of the EMU's rules. None of them reflect the opinions of the two extremes but instead take a much more practical middle way. Driven by the crisis, and with their form determined by the often divergent interests of the summit delegates, actions have been agreed to remove certain weaknesses in the economic and fiscal governance of the monetary union. These included

- the *introduction of the European Semester* as a means of coordinating economic and fiscal policies ex ante with effect from 1 January 2011,

- the voluntary commitments to political reforms on the part of Member States within the framework of the *Euro Plus Pact*, adopted in March 2011 with the aim of improving economic cooperation to strengthen competitiveness and achieve greater convergence,

- and the so-called Six Pack of *changes in legislation to reform the Stability and Growth Pact* (SGP)

- and to introduce *new procedures for dealing with macroeconomic imbalances* (which came into force in 2011). On 2 March 2012, 25 EU Member States finally signed the *Fiscal Compact*. Along with the requirement to maintain a balanced budget, this compact included the introduction of stronger automatic sanctions within the framework of the SGP (cf. ECB 2012a, p. 85-87; Becker, W. 2012, p. 13).

- At the meeting of the European Council on 29 June 2012, the European Union's heads of state or government also agreed to a *Compact for Growth and Jobs*, including steps designed to stimulate growth, investment and employment and to increase the competitiveness of the individual Member States.

- The members of the euro area also agreed *to set up a single mechanism for banking governance under the ECB* and once this mechanism was in operation to give the ESM the possibility of direct bank recapitalisation.

- In addition, it was decided that funds from the *EFSF and ESM firewalls* set up in 2010 should be made available to buy government bonds from crisis-hit countries that comply with the relevant recommendations and requirements (European Council 2012a, p. 1, 7-17; European Council 2012b, p. 1).

Although the measures agreed may seem somewhat unsystematic in light of the extreme opinions expressed on the best way to manage the crisis, in fact they are targeted at the three main weak points in the Maastricht Treaty:

- stronger automatic sanctions and Europeanisation of national fiscal controls,
- improved coordination and handling of macroeconomic imbalances between Member States,
- a common stability mechanism to protect against erratic fluctuations in the capital markets, combined with a decoupling from the banking crisis and sovereign debt crisis.

We will now look at the summit decisions in the relevant areas of activity. The focus of our analysis will be on an evaluation of the Fiscal Compact, the Pact for Growth and Jobs, the establishment of a uniform banking governance mechanism as the first step towards banking union and the possibilities presented by the EFSF and ESM. In so doing we will need to consider both the long-term and short-term implications.

4.1 The Fiscal Compact for Greater Budgetary Discipline

As previously mentioned, supporters of the original Maastricht approach advocate the introduction of strict measures by the Member States in order to improve their domestic budgetary discipline and ensure the continuing existence of the euro area (cf. Issing, O. 2009, p. 3; Sinn 2012, p 39). In March 2012 the heads of state or government signed the Fiscal Compact in order to underline their political will to increase budgetary discipline. The Fiscal Compact tightens up the coordination of budgetary policy and clearly sets out the rules on sanctions. For example, the Member States agree to include various new fiscal rules such as the debt brake in their domestic rules and either balance their domestic budgets or achieve a surplus. Structural deficits are not allowed to exceed 0.5 percent of GDP (European Council 2011b, p. 3).[2] The Fiscal Compact still upholds the principle that each Member State should continue to be responsible for their domestic budgets, but it limits their sovereignty over their budgets if they fail to comply with the terms of the Compact. The Fiscal Compact is a positive step because it can make a lasting contribution towards achieving more stability in national finances, but in the short term it has had little effect because the markets have been focused on the problems relating to growth and the banks.

The reform of the SGP as part of the so-called Six Pack is also a significant structural decision in favour of increased budgetary discipline. It aims to deal with and punish any breaches of budgetary discipline at an early stage and reinforces the preventive arm of the Pact by means of stronger restructuring requirements when the economy is good – including the possibility of sanctions. One of the changes is the obligation for countries with high levels of sovereign debt to repay one-twentieth of the debts that exceed the 60 percent of GDP mark each year. The imposition of sanctions for excessive budget deficits can only be prevented by a reverse qualified majority of Member States. This lowers the risk of policy dilution[3] (EZB 2011, pp. 107-108). It limits the budget sovereignty of states that are in breach of deficit rules and increases the incentive to maintain greater budgetary discipline.[4]

In terms of practical policies, it is essential that all euro area countries with excessive budget deficits take credible steps towards consolidation. According to the summit decision, excessive budget deficits are to be brought below 3 percent of GDP by 2013.[5] It remains to be seen whether this will be enough to restore confidence. One of the core problems is the fact that the adjustment programmes that are necessary for consolidating budgets place additional burdens on an already weak economy. In turn, this heightens the worries of investors about debt sustainability and in view of the unresolved banking problems this weakens the usual confidence-building effect of imposing consolidation measures. So it is of critical importance to gain control of the growth and banking problems that are besetting the euro area.

4.2 The Stability and Growth Pact and Competitiveness

Once the previous growth models of financing domestic demand through government loans were rendered obsolete in the worst-hit countries of the euro area, the question now arises of how to find new sustainable growth models. Of course the best solution would be if these euro area countries could grow their way out of their debt crises, but domestic and global economic conditions make this unlikely. The banking crisis, along with a lack of confidence and competitiveness, affect the companies propensity to invest and to finance their growth.

Whatever happens, the starting point for future policies for growth must be to correct the previous erroneous trends in capital appropriation. So, for example, in Greece inflows of capital were used to finance a massive national deficit, while in Ireland and Spain the property market was booming until the bubble burst and unleashed problems in the banking sector (cf. Pessoa, A. 2011, p. 5). It is essential to re-establish sound national finances and introduce structural reforms in order to reinforce competitiveness, export strength and growth.

With the Compact for Growth and Jobs, the June 2012 summit set the right fundamental course. One of its main focuses is growth-friendly fiscal consolidation that still boosts investment in areas such as innovation and education. It also actively tackles the recapitalisation of the banking sector, a core problem in the crisis-ridden countries of the euro area.[6] The summit approved a growth plan to the tune of €120 billion, or 1 percent of the EU's GDP (European Council 2012a, p. 11). This relatively small sum can be explained by Europe's major debt problems, so it is more of a political than economically-effective decision in favour of more investment in medium-sized businesses and infrastructure in the problem countries of the euro area. To this end, the funds held by the European Investment Bank for loans and guarantees were massively increased, despite the fact that in the past these have only been partially drawn on because of the lack of absorptive capacity. So it is all the more important for the problem countries of the euro area to redouble their export efforts. The refocusing of the growth model on increased exports represents a structural change that will initially and inevitably set back growth and affect the labour market. It will take time to reap the rewards of reform dividends after returning to a path of sustainable growth. So it is important that politicians view the planned reduction in levels of sovereign debt as a project for the medium term. The financial markets expect to see a credible programme of fiscal consolidation in the medium term that will not damage growth and revenues in the short term (IMF 2010, p. 7-9).

The classic method of correcting lack of competitiveness through devaluation is no longer an option in the EMU, and pulling out of the EMU altogether is also of little help. Therefore internal adjustments through fiscal consolidation and structural reforms have become extremely important. Structural reforms are also necessary to reignite competitiveness in the euro area's problem countries. More specifically, it is a question of reducing the high current account deficits that built up before the outbreak of the sovereign debt crisis in 2010. The European Council has introduced two important measures to improve the architecture of the EMU and work towards reducing these deficits.

The Euro Plus Pact of 2011 calls for concrete economic and political reforms to increase competitiveness. Based on specific indicators such as unit labour costs, this Pact obliges the euro area countries to announce each year a package of specific structural policy measures that have to be implemented during that year. This primarily relates to structural reforms to the welfare system and the labour market (see European Council 2011a, pp. 13-20). For example, one of its aims is to make the necessary structural changes easier by making the labour market more flexible. It also aims at relieving the burden that the welfare system places on the economy, for example by raising the pension age. However, it remains to be seen whether the Euro Plus Pact will succeed in making lasting improvements to the way economic policies are coordinated as it is not proposed to impose sanctions.

In this respect we should also note the new governance procedure for preventing macroeconomic imbalances, introduced as part of the so-called Six Pack. The new procedure is designed to help the Commission identify and correct macroeconomic imbalances – such as excessive current account deficits – by means of economic indicators. Sanctions may be imposed in cases of excessive imbalances and a lack of willingness to carry out corrective steps. The threshold for current account deficits is set at 4 percent of GDP and at 6 percent for surpluses (European Commission 2012a, p. 3). This is an appropriate approach because excessive current account deficits form part of the debt problem.

4.3 A New Building Block in the EMU Structure: A Banking Union

The June 2012 summit put the creation of a European banking union on the political agenda in order to break the "vicious circle between banks and sovereigns" (European Council 2012b, p. 1). The banking union consists of four elements:

- Europe-wide regulation of financial services,
- a new European institution for financial governance,
- a mechanism for dealing with problem banks and
- a harmonised system for guaranteeing deposits (Speyer, B. 2012, p. 4).

However, the main problem is the fact that it takes time to construct an effective banking union.

In the short term, it is essential to carry out ad-hoc crisis management in order to limit the risks to the stability of the system and the integration of the financial markets and to restore confidence. Many banks in the worst-hit euro area countries suffer from weak capital and earnings ratios and slow value adjustments on problem loans to the private sector and government bonds. Weakness in the banking sector creates distrust among depositors and banks alike. This does a great deal of damage to the recapitalisation of many banks in line with market conditions, which is why the ECB has been right in saying that the capital market and the transmission mechanisms for monetary policy have been permanently damaged in the euro area (ECB 2012c, p. 62). Low equity also means that banks are less able to make business loans, which in turn has an impact on growth.

So the focus of crisis management must be on a taking an immediate inventory of the credit risks and equity of the banks in the affected euro area countries. This should involve the adjustment of bank balance sheets using transparent, credible value adjustment methods, the recapitalisation of those banks that have positive prospects and the liquidation of those that do not.

If it is difficult or impossible to attract capital from the market, so it falls to governments and taxpayers to dig deeper into their pockets. For example, regardless of the decision made at the June 2012 summit, the ESM permanent rescue fund should only be handed the possibility of directly recapitalising the banks once a single supervisory mechanism for banks has been set up. In the case of Spain, external funds are urgently needed to restructure the banking sector in order to limit the risks of contagion. Of course the key question when seeking external assistance for the banks in a euro area country is how to handle issues of liability and supervision. In a banking union, taxpayers' money from other countries in the union would be used, but those who bear the risk must also have supervisory rights. Such rights could be established for a transitional period during times of crisis.

Some critics believe the state recapitalisation of banks in the euro area using capital from the rescue fund to be a major breach of regulatory policy, firstly because of the associated mutualisation of risks and secondly because of the use of public money to bail out banks (Krämer, W. and Sinn, H.-W. 2012, p. 11; Sinn, H. W., Abele H., Abelshauser, W. et al. 2012, p. 11). But these critics are overlooking the fact that investors can well afford to make a financial contribution. The mutualisation of bank risks is also supposed to take place within the EMU as part of a uniform system of European bank regulation and be organised in accordance with the insurance principle. This firstly ensures an improvement in bank regulation compared to the previous system of national governance, particularly for banks that also operate outside their national borders. Secondly, before joining the joint fund, every financial institution will be tested for stability in terms of its capital ratio and risk position. Bailout funding such as that given to the Spanish banks before the fund was set up can and should be paid back after successful recapitalisation.

Going beyond short-term crisis management, the elements of the banking union can make a lasting contribution to providing a much sounder foundation for the EMU and its banking system. With the implementation of the Financial Services Action Plan (FSAP) up to 2005, the EU had already made significant progress in creating a single supervisory framework for financial services.[7] Another significant step is now the implementation of tighter rules on capital and liquidity for EU banks in line with Basel III.[8] It would help the EU's crisis management – at least psychologically – if Basel III were passed without delay, but there will still be long transition periods until 2019 for Basel III to come into force.

The second element of a banking union – the creation of a central European bank regulatory authority as a new institution with effective structures – seems to be a positive step in view of the tightly-woven financial markets and associated risks of contagion. There is also a moral hazard problem, as national bank regulatory bodies in EMU countries have an incentive either not to disclose risks or to push them onto Europe in order to divert attention from their own regulatory failings (German Council of Economic Experts 2012, p. 27 f.). However, the establishment of a central bank regulatory authority is bound up with the transfer of a considerable degree of the banking sector's sovereignty that goes far beyond that envisaged by the new regulatory framework for the EU proposed by Basel III.

The statement of the Euro Area Summit held on June 2012 stipulates that the European Commission should present "proposals for a single supervisory mechanism, involving the ECB" as soon as possible (European Council 2012b, p. 1). However, the total relocation of European bank supervision under the umbrella of the ECB is not without problems. This could lead to conflicts of interest between its monetary mandate and its key role on the European Systemic Risk Board. For example, the ECB would be in danger of risking its reputation as a bank supervisor with attendant potential negative consequences for the credibility of an independent monetary policy. So when designing a new European regulatory system it would be better to create a new institution that can carry out its supervisory duties in close cooperation with the ECB (Speyer 2012, p. 7).

The third element of the banking union is the establishment of a mechanism for the orderly restructuring and resolution of problem banks in the euro area in order to avoid taxpayer-funded bail-outs of these banks in future due to the need to stabilise the system. Of course the implicit guarantee to bail out major banks must be linked to considerable disincentives with regard to risk appetite. There are a number of political, legal and organisational issues that need to be cleared up in relation to the institutional structure of a European restructuring mechanism (Speyer 2012, p. 8 f.). It is necessary to decide how it should be organised, for example whether the mechanism should come under the auspices of the European Commission or the ESM or whether a new institution should be set up to house it. The European Commission's responsibility for competition policy in Europe would seem to make it the preferred choice, but the question must be asked whether skills in the area of competition policy are sufficient to handle the restructuring and resolution of problem banks. It also needs to be decided how the burdens of restructuring will be distributed, for example whether a fund should be set up that is financed by banks across the EU and that takes into account the risk profile of the respective institute.

Finally, a banking union raises the question of introducing a pan-European deposit guarantee in order to prevent a run on savings with the associated negative consequences. To date, EU states have provided their own deposit guarantees, subject to certain minimum requirements. From 1 January 2011 these guarantees have been harmonised at €100,000 per customer. But as each EU state is liable for the deposits, savers in the euro area's problem countries are becoming increasingly sceptical about whether their debt-ridden governments will actually honour these guarantees and are withdrawing their savings.

In a banking union, the mutualisation of deposit guarantee systems should lead to greater stability for the stricken banking system. It is our opinion that this should only include statutorily guaranteed deposit guarantee funds and not private funds that, for example in Germany, far exceed the statutory levels of deposit insurance. Alternatively, consideration could be given to taking out insurance that is only used if the national deposit guarantee systems are unable to cope. There would have to be joint liability for the insurance premiums, for example via the ESM (Speyer 2012, p. 9).

Three of the four elements of the banking union – European banking supervision, a bank resolution mechanism and pan-European deposit insurance – inevitably require a transfer of sovereign rights and also, to some extent, joint risk liability through public money. The banking union therefore necessitates centralising powers of intervention in the banking sector, for example in the ECB or the Commission. And on the issue of transfers, the question of the interplay of liability and supervision must be adequately clarified.

4.4 EFSF and ESM: A Need for Robust Rescue Funds

The establishment of jointly-guaranteed stability mechanisms has attracted harsh criticism from supporters of a minimalist approach to resolving the crisis (cf. Blankart, p. 14). With the first rescue package for Greece on 2 May 2010, the "no bail-out" clause was diluted for the first time. After Greece's bail-out by its euro area partners, the financial markets immediately began speculating on potential bail-outs for other Member States, resulting in other euro area countries with weak fiscal positions quickly suffering the effects of strong financial contagion. Once again, the governments took quick and decisive action and on 9 May 2010 they joined forces with the IMF to set up a massive rescue fund totalling €700 billion. This was the beginning of the establishment of rescue funds and firewalls to counter the effects of financial contagion. But neither the temporary EFSF mechanism set up at that time nor the permanent ESM[9] established in 2012 have so far succeeded in bringing lasting stability to the markets.

As previously discussed, rescue funds are considered problematic in terms of regulatory policy because they are in breach of the "no bail-out" clause. But this is only half of the story. One lesson that has been learned from the crisis is the need to prevent contagion. In times of crisis, a firewall can play an important stabilising role as long as two conditions are met. The first of these is the need to link EFSF and ESM loans to strict conditions in order to avoid disincentives, as a moral hazard problem ensues when governments can run up huge deficits, safe in the knowledge that they will be bailed out. And in order to restore confidence it is equally important that the IMF is involved by providing advice and funds. Problem countries can continue to buy time to restructure their budgets using precautionary conditioned ESM credit lines. Secondly, the firewalls have to be large enough and robust enough to convince the market of their effectiveness in an emergency. The standard size of the firewall does not have to correspond to the total amount of sovereign debt in the problem countries of the euro area. But if it is to have the confidence of the markets, it must at least cover refinancing requirements for the next two years.

The summit decisions and their implementation were somewhat problematic with regard to the size and robustness of the firewalls. For example, the controversial debate about the actual or proposed amounts that the Member States are obliged to guarantee did little to inspire confidence (Homburg, S. 2012, p. 11; Kampeter S. 2012, p. 11). The attempt to leverage the amounts with financial products was also of little help, and the idea of giving the ESM a banking licence also proved to be unconvincing. In crisis situations it is instead necessary to introduce very high guarantee amounts in order to convince the markets of the political will to avoid financial contagion. These need to be introduced very speedily by the euro area countries, if necessary with the simultaneous use of all available means, such as the provision of state guarantees, securities (e.g. currency and gold reserves), IMF facilities and insurance agreements with the private sector. These possibilities have not yet been exhausted, including the option of combining the liability amounts of the temporary EFSF rescue fund with those of the permanent ESM, at least temporarily. Politicians are also considering the option of the ESM and ECB working together in the market in order to demonstrate their will to stabilise the situation.

These and other actions certainly involve a degree of conflict between regulatory considerations and effective ways of preventing contagion. But these conflicts should be put to one side in view of the scale of the crisis in order to avoid even worse problems. For example, it is conceivable that the size of the firewalls could be reduced after the crisis has been successfully overcome.

5. CONCLUSION

The European banking and sovereign debt crisis has caused great turbulence in the EMU and laid bare the shortcomings in its existing structures. These include an inadequate mechanism for implementing sound national fiscal policies, a lack of coordination in containing macroeconomic imbalances, an absence of robust financial firewalls to protect against loss of confidence in the financial markets and a mechanism for the smooth resolution of problem banks.

In response to the crisis, economic experts have identified two possible solutions that are totally at odds with each other. On the one hand, the proposal that the sovereign debt of the euro area states should be partly or totally mutualised and that Europe should have supervisory control over their national budgets. The second solution involves the intention of reverting to the terms of the Maastricht Treaty and the Stability and Growth Pact while at the same time maintaining strict separation between European monetary policy and national fiscal policy.

In parallel, the actions agreed by European politicians over the course of the crisis have been criticised by many experts as being either inadequate or in breach of regulatory principles. This article attempts to show that the crisis-driven pragmatism of politics is in fact an appropriate way of resolving the crisis and placing the EMU on a new, more stable footing. On the other hand, the proposals on economic policy emanating from the extreme poles in this debate – the "integrationists" and the "minimalists" – do not appear to offer practical solutions to the crisis because they either imply illusory political circumstances or puristically hold firm to a failed construct.

In actual fact, the political actions that have been agreed upon have addressed the structural shortcomings of the EMU:

- The Fiscal Compact – in combination with the Six Pack – has succeeded in placing national fiscal policies on a more solid footing and decoupled the deficit procedure from national influences.
- And with the European Semester, the Euro Plus Pact, the Macroeconomic Imbalances Procedure and the Growth Pact, the coordination of economic policy and regulation of macroeconomic imbalances has been improved, while at the same time strengthening competitiveness and growth.

- And thirdly, the creation of the ESM in combination with the plan to establish a single European supervisory mechanism has prevented loss of confidence in the financial markets and severed the fatal ties between debt crisis and banking crisis.

The agreed actions attempt to elevate important elements of the social market economy to a European level. If we ignore the ECB measures, as they to some extent contradict the German concept of monetary policy, this has been achieved thanks to binding agreements such as the Fiscal Compact and the Six Pack. These elements underline the fact that a European economic model has to be based on sound national finances and competitive structures. The ESM does not fundamentally contradicts the German belief in individual responsibility and liability, but rather it provides an instrument for guaranteeing liquidity in exceptional situations and based on strict conditionality. Countries can only request a bail-out if they commit themselves to an adjustment programme that aims to resolve the problems. This instrument has made a crucial contribution to the ability of European governance structures to effectively counter the risks of contagion. Along with the other elements discussed, this creates a sound regulatory framework. This kind of framework, one that specifically includes the financial markets, was one of the fundamental concerns of the founding fathers of the social market economy.

Now more than ever, the debate on an effective economic policy for Europe is at the centre of European attention and Germany has a wealth of relevant experience to bring to the table. In all honesty, even Germany has not always been absolutely strict about aligning it with some of the major principles of the social market economy. But there is little credibility in stubbornly clinging to principles at a European level. In terms of economic policy, it should be Germany's aim within the EU27 to export as many basic principles as possible from German *Ordnungspolitik* and anchor them in the institutions of the euro area. This can only be achieved through pragmatic and consensus-oriented economic policies because of course other European nations also have their own legitimate interests. The political decisions of the recent years of crisis should be grounds for optimism in this respect. They include more of the building blocks of the social market economy than is recognised by many of their critics.

A critical factor in overcoming the crisis and returning to stability will be the targeted and speedy implementation of these decisions by European politicians. This is particularly the case when it comes to recapitalising stricken banks and reducing excessive risk premiums for the problem countries of the euro area. Greece remains a special case, as it is unlikely to emerge from the crisis without further debt rescheduling or an ESM-funded buyback programme. The role of the ECB is also controversial in the EMU's crisis management, with the actual or planned purchases of government bonds on the secondary markets being criticised as monetary state financing. But we believe this can be interpreted another way. The exceptional actions of the ECB are a temporary substitute for the absence of European policy measures to stabilise the EMU and calm the financial markets. Conversely, by implementing their decisions, particularly in the form of the ESM permanent rescue fund, politicians can lead Europe's monetary policy away from being the lender of last resort and return it to its original mandate of money supply and controlling inflation.

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2| *The Fiscal Compact is an intergovernmental treaty outside of European Union law that was signed in March 2012 by 8 of the 10 EU countries that are not members of the EMU. It entered into force on 1.1.2013. Only the UK and the Czech Republic refused to sign. For an overview of the main elements of the Fiscal Compact, see ECB 2012a, pp. 89-91.*

3| *In the "old" SGP, states that were potentially in breach of the debt and deficit limits ruled on penalties for states that were actually in breach, with the result that since 1999 many cases of excessive deficits have not been punished with sanctions.*

4| *For a comparison of the Fiscal Compact and the reformed SGP, see ECB 2012a, pp. 95-102.*

5| *Exceptions are Greece, Ireland and Portugal, which have for years now been attempting to consolidate their budgets with the help of assistance and adjustment programmes, with varying degrees of success.*

6| *The decisions can be found in the appendix to the Conclusions of the European Council on the meeting of 28/29 June 2012, European Council (2012a), pp. 7-15.*

7| *The Financial Services Action Plan (FSAP) includes 42 individual projects in the EU's banking, securities and insurance sectors.*

8| *The new capital requirements under Basel III originally due to come into force on 01.01.2013 are still pending due to disagreements on certain points between the Council and the European Parliament. The new Basel III "single rulebook" strengthens bank capital requirements (e.g. equity capital for listed companies, retained profits). Core tier one capital ratios will rise to 7 percent by 2019. Basel III will also introduce two new capital buffers so that banks are better placed to absorb their risks. Firstly, a mandatory capital conservation buffer of 2.5 percent by 2019, and secondly an anticyclical capital conservation buffer that should climb steadily to 2.5 percent by 2019. Both buffers must use tier 1 capital. The generous transition period gives the banks time to build up this capital without the need to restrict lending.*

9| *The ESM (European Stability Mechanism) has €700 billion at its disposal, based on guarantees (€620 billion) and capital payments (€80 billion) from the euro area countries. The level of these payments and guarantees is decided according to their share of ECB capital. Germany's share amounts to 27 percent or €190 billion.*