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The Eurozone Crisis: Between the Global Financial Crisis and the Structural Imbalances of the EMU

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2.1 Introduction

This chapter places the sovereign debt crisis of the so called 'PIIGS' group of European Union (EU) member states (made up of Portugal, Ireland, Italy, Greece and Spain) within the context of the structural imbalances characterising the Economic and Monetary Union (EMU) from the onset.

It is argued that the global financial crisis, given the structural differences of the different Euro Area members states, acted as an asymmetric shock which exacerbated a structural problem of competitiveness embedded in the way in which the EMU was originally devised and implemented. By no means was the crisis only the result of an unsustainable fiscal position in the PIIGS member states. If anything, it confirmed the lack of sustainability of a structurally asymmetric monetary union in the wake of an extremely serious economic shock. This has meant

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bringing the PIIGS group to the verge of the abyss, despite many voices having warned at the onset of EMU about the need for more symmetric arrangements in Europe and the development of more fiscal and political integration.[1]

This chapter addresses these issues, starting with the unfolding of the Eurozone crisis. It will then identify the structural imbalances of the EMU. Finally, it will assess the solutions that have seemingly been found to the crisis and their impact on the future of the EMU and of the PIIGS within it.

2.2 The Global Financial Crisis and the Crisis of the Eurozone

The global financial crisis was an unprecedented blow to the global economy resulting in consequences that still need to be fully appreciated.

Scholars identify five different stages in the unfolding of the global financial crisis.[2] The first stage is the collapse of the US subprime mortgage market. This spilled over into the credit market with a credit crunch that led to a third phase, represented by the liquidity crisis. The fourth phase was represented by the commodity price bubble and the fifth by the demise of investment banking in the USA.[3]

Eventually, the decision to pump an enormous amount of public money into the global financial markets averted the catastrophe. But the financial crisis had already spilled over into an economic crisis, with Ireland being the first Eurozone country to technically enter into recession in September 2008.[4] In only two years, the world as a whole

[1] See Talani, L.S., (ed), (2009), The future of EMU, London: Palgrave.

[2] Orlowski, L.T., (2008). *Stages of the 2007/2008 Global Financial Crisis: Is There a Wandering Asset-Price Bubble?*, Economics Discussion Papers, No 2008–43. http://www.economics-ejournal.org/economics/discussionpapers/2008-43 as accessed on May 18, 2009.

[3] Orlowski, L.T., (2008). *Stages of the 2007/2008 Global Financial Crisis: Is There a Wandering Asset-Price Bubble?*, Economics Discussion Papers, No 2008–43. http://www.economics-ejournal.org/economics/discussionpapers/2008-43as accessed on May 18, 2009.

[4] Sinn, H.W., (2010), *Casino Capitalism*, Oxford: Oxford University Press.

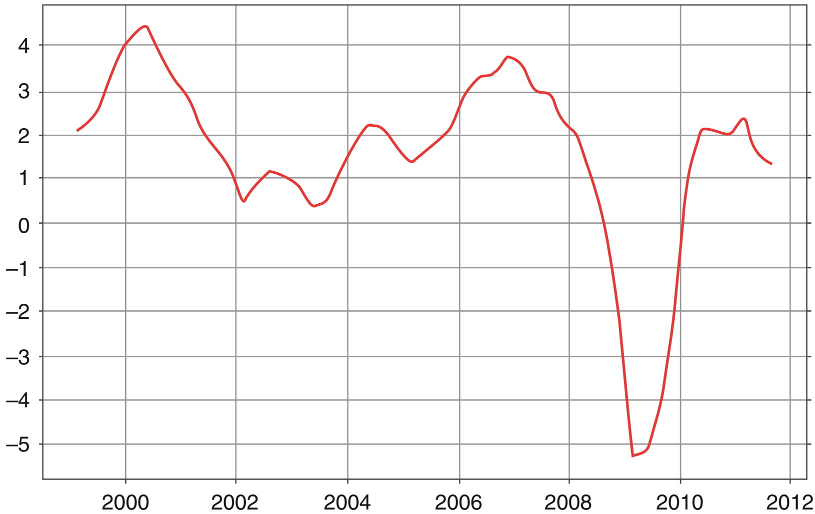

Fig. 2.1 GDP changes in the Eurozone 2000–2012 (*Source*: ECB web-site: http://www.ecb.int/home/html/index.en.html as accessed on June, 13 2012)

experienced a GDP reduction of 6 %, from 5.2 % to –0.8 %, the sharpest ever recorded in history.[5]

In the Eurozone, GDP fell even more sharply, recording an incredible loss of 9 % from 3.8 % in 2007 to –5.2 % in 2009 (Fig. 2.1).

The last phase to date in the unfolding of the crisis was the outburst of a sovereign debt crisis in the Euro Area, first in Greece, in May 2010, then in Ireland at the end of November 2010, and finally to all the members of the so-called PIIGS group.

Greece was the first casualty in May 2010. The fact that its debt had been downgraded by Moody's a few days prior did not help to avoid speculation, nor did the long time taken by other members of the Euro Area before deciding to provide a rescue package. This package included the establishment of an ad-hoc European Financial Stability Facility (EFSF).[6] Second in line was Ireland, which was plagued by the ongoing

[5] Sinn, H.W., (2010), *Casino Capitalism*, Oxford: Oxford University Press, p. 6.

[6] See BBC News, available at http://news.bbc.co.uk/2/hi/business/8671632.stm as accessed on December 22, 2010. See also below this chapter.

crisis of its banking system at the end of November 2010. Although its European partners had approved a rescue plan providing an overall €85 billion (€35 billion to bail out the Irish banking system with the remaining €50 billion to help the government's day-to-day spending), the markets insisted on increasing the yields required to buy Irish bonds (as well as Greek, Portuguese, Spanish and Italian ones).[7] Amid serious worries for the stability of the entire system, on 16 and 17 December, 2010 the European Council moved toward the institutionalisation of a rescue tool called the European Stability Mechanism, which was officially launched on 8 October, 2012.[8]

However, in December 2010 the financial and economic situation in Europe and especially in the Eurozone was heavily compromised. The main problems were found in the interplay between sovereign debt difficulties and the weakness of the banking sectors of some countries with the euro. Taken together, these issues could bring serious consequences for the sustainability of the EMU as a whole.

In its assessment of the main risks for the financial stability of the Eurozone, the European Central Bank (ECB) differentiated between sources outside the financial system and sources of concern inside it.[9] Outside the financial system, the main sources of risk for Eurozone financial stability included the possibility of new concerns with respect to the sustainability of fiscal stances in some member states; a resurgence of global imbalances; vulnerability of non-financial corporations' balance sheets; and macroeconomic problems related to the increase of unemployment and related reduction of private credit. Within the Eurozone financial system, important risks included the possibility of new strains to the financial system; more problems with banking exposure to bad debt;

[7] See BBC News, available at http://www.bbc.co.uk/news/business-11860879 as accessed on December 22, 2010.

[8] See BBC News *Q&A: The European Stability Mechanism*, available online http://www.bbc.co.uk/news/business-19870747 as accessed on October 9, 2012.

[9] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

and increase in the volatility of financial markets in the lack of macroeconomic recovery.[10]

The main worry that remained, however, was concerning the lack of sustainability of public finances in some Eurozone countries, which had prompted market speculation against Greece. This had already created an adverse feedback loop between lower economic growth, bank funding vulnerabilities and fiscal imbalances, as was reflected in increases in the persistently growing spread between Eurozone sovereign bond yields.[11] On the other hand, the profitability of many Eurozone large and complex banking groups (LCBGs) continued recovering in the second and third quarters of 2010, demonstrating how the banking sector had succeeded in shifting the burden of the financial crisis.[12] Finally, concerns were voiced with respect to the possibility that global financial imbalances could widen again, thus creating new strains on the fiscal and financial sectors of some Eurozone countries.[13]

Similar worries were confirmed in 2010 and 2011 when the Greek, Irish and Portuguese spreads with the German Bund hit, respectively, 1600, 1200 and 1100 basis points in July 2011. Also, the Spanish and Italian sovereign debt spreads with the Bund reached 400 basis points, Belgium hit 200 basis points and France hit 90 basis points.[14]

In 2012 the situation was still extremely worrying, with Spain having to accept a sort of bailout for its endangered banking sector of about 100 billion euros and Italy being widely considered the next in line.[15]

[10] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[11] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[12] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[13] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[14] ECB (2010) Financial Stability Review available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[15] See Financial Times, June 13th 2012:, available at http://www.ft.com/cms/s/0/d2d42d1e-b36c-11e1-83a9-00144feabdc0.html#axzz1xfURTAr3 as accessed on June 13, 2012.

2.3 The Eurozone Crisis: A Fiscal Crisis?

Much of the blame for the sovereign debt crisis has been put on the dire situation of the PIIGS' fiscal stance. Although it cannot be denied that the countries considered were not enjoying a healthy budgetary situation, it must be noted that the policy of fiscal stimulus to combat the crisis came at a high cost for the fiscal position of many other countries. For example, the newly elected Obama administration introduced a stimulus package of $800 billion, bringing the budgetary deficit to 10 % of GDP in 2009. A similar figure was envisaged for the same year in Japan, while in the UK the deficit to GDP figure was almost 13 %. In the Eurozone, the deficit to GDP was on average only 6 % in 2010, whereas in the mid 1990s it had reached more than 7 %.[16] The situation was, of course, different in the different countries of the Eurozone. However, with respect to the case of the Eurozone periphery, two points must be stressed.

First, some of the countries which have since been affected by the most serious run on their sovereign debt were by no means performing so badly in terms of deficit to GDP in the course of the crisis. In 2010, when the attacks started, Greece had a deficit to GDP of 10.3 %, only 4.3 % higher than the Eurozone average which was 6 % at the time. Portugal and Spain with 9.8 % and 9.3 %, respectively, were just around 3.8 % and 3.3 % higher than the Eurozone average.[17] Italy had actually been doing quite well in the course of the crisis, better than the average of the Eurozone, with a deficit to GDP of only 4.6 % in 2010, which had even declined from 5.4 % in 2009. Of course, commentators then blame the Italians for having an outrageous debt to GDP ratio. However, it is worth noting that in 1995 this ratio was 121.5 % against an average of 72.5 % in the rest of the future Eurozone, whereas by 2010 the difference between the Italian performance and the average of the Eurozone had actually decreased from 49 % in 1995, to 34 %.[18] Moreover, in 2010 Spain had a debt to GDP ratio of 61.2 %, much below the Eurozone average of

[16] See ECB statistics, available at http://www.ecb.int/stats/gov/html/dashboard.en.html as accessed on October 9, 2012.

[17] Ibid.

[18] Ibid.

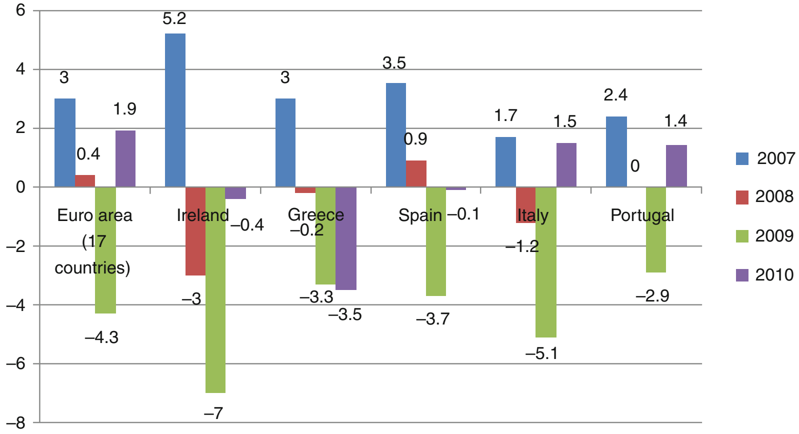

Fig. 2.2 Real GDP loss 2007–2010 (*Source*: EUROSTAT elaboration of the author)

85.2 %, and also Ireland and Portugal were not doing that badly with figures of 92.5 % and 93.3 %, respectively.[19]

Finally, similar performances of the deficit and debt to GPD ratio must be seen in the context of spectacularly declining levels of GDP which by definition, if only for mathematical reasons, increases their values. Between 2007 and 2009, Ireland lost 12.2 % of its real GDP, Greece 6.5 %, Spain 7.2 %, Italy 6.8 % and Portugal 5.3 % (Fig. 2.2).

2.4 The Global Financial Crisis as an Asymmetric Shock

In an effort to identify the relationship between the global financial crisis and the crisis of the Eurozone, it is important to ask, along with the relevant literature, two questions.[20]

[19] Ibid.

[20] See Manganelli, S. and Wolswijk, G. (2009),"What drives spreads in the euro area government bond market?", *Economic Policy*, 24: 191–240. Arghyrou, M.G. and Kontonikas, A., (2010) *The EMU sovereign-debt crisis: Fundamentals, expectations and contagion*, Cardiff Economics Working

First, are the larger spreads recorded in the course of the crisis a consequence of larger fiscal deficits and debt or do they show a change in the attitude of the markets towards the pricing of government credit risk?

Second, to what extent did the global financial crisis modify the attitude of the markets towards credit risk in the direction of more risk aversion?

The empirical results of a study conducted by the ECB shows that markets penalised fiscal imbalances much more strongly after the collapse of Lehman Brothers in September 2008, to the extent that coefficients for deficit differentials were 3–4 times higher and for debt differentials 7–8 times higher during the crisis period than earlier.[21] So, to answer the first question, the markets clearly changed their attitude towards pricing of government credit risk in the course of the global financial crisis and in its aftermath. But why did they do that? First the study underlines how there was a significant increase in bond spreads due to a general increase of risk aversion. This makes a lot of sense if we think that over the course of the crisis, the collapse of the stock exchange and of the housing market together with a general uncertainty about exposure to very risky assets of most of the banking system made it imperative to look for safe havens in which to invest. Indeed, the price of commodities such as gold and oil went up as a consequence of the general instability of other forms of investment, and this lead to a commodity price bubble which is considered in the literature as the fourth phase in the development of the crisis.[22] Also government bonds in the USA and, after the

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Paper, N. E2010/9. See also Monfort, A., and Renne, J.-P., (2011) *Credit and liquidity risks in Eurozone sovereign yield curves*. Paris: Banque de France Working Papers Series, n. 352. Haugh, D., Ollivaud, P., D. Turner, (2009) *What drives sovereign risk premiums? An analysis of recent evidence from the Eurozone*. Paris: OECD Economics Department Working Papers, N. 718. Gerlach, S., Schulz, A. and G.B. Wol (2010).*Banking and sovereign risk in the euro area*..CEPR Discussion Paper, n. 7833. Attinasi, M.G., Checherita, C., and C. Nickel, (2009). *What explains the surge in euro area sovereign spreads during the financial crisis of 2007-09?*. ECB Working Paper Series, n. 1131. Barrios, S., Iversen, P., Lewandowska, M. and R. Setzer, (2009) *Determinants of intra-Eurozone government bond spreads during the financial crisis.* Brussels: European Commission, Directorate General for Economic and Financial Affairs, Economic Papers, N. 388.

[21] Manganelli, S. and G. Wolswijk, (2009)"What drives spreads in the euro area government bond market?". *Economic Policy*, 24: 191–240.

[22] Orlowski, L.T., (2008). *Stages of the 2007/2008 GlobalFinancialCrisis: Is There a Wandering Asset-Price Bubble?*, Economics Discussion Papers, No 2008–43. http://www.economics-ejournal.org/economics/discussionpapers/2008-43 as accessed on May 18, 2009.

start of the crisis, Germany (the benchmark in the euro-denominated bond market), assumed a safe-haven investment status. Furthermore, not only were investors/markets generally more risk averse, but they were also penalizing fiscal imbalances much more strongly than before September 2008, as demonstrated by the ECB study. These two factors account for much of the spread increase for EU country government bonds relative to German or US treasury benchmarks.[23]

It is indeed remarkable that US government bonds, the country where the crisis had started and which was experiencing huge fiscal imbalances, instead of becoming more risky were unanimously considered by the markets as a safe haven in which to invest in a period of instability.

The case of Germany, however, is less puzzling. In the whole process of European monetary integration, from the establishment of the exchange rate mechanism of the European Monetary System onwards, Germany had been the '1' country of the 'n-1' problem, in other words the country with the strongest currency which could, because of the technical characteristics of the fixed exchange rate arrangement, define the monetary policy for all the members of the currency agreement.[24] More specifically, the 'n-1' problem means that in a fixed exchange rate system there are only 'n-1' independent exchange rates, and therefore, while 'n-1' countries have to use their monetary policy so as to keep their exchange rate fixed, there is always'1' country, the one with the strongest currency, which is free to set its monetary policy independently of exchange rate constraints. Moreover, by definition, the '1' country is the one with the strictest, more credible, anti-inflationary monetary policy which allows its currency to be stronger than the currencies of the other members of the Union. This, however, has evident consequences for the competitiveness of the 'n-1' countries, which experience higher inflation rates and therefore progressively lose competitiveness up to the point at which their exchange rate becomes unsustainable and the markets can successfully speculate against their currencies.

[23] Manganelli, S. and G. Wolswijk, (2009) "What drives spreads in the euro area government bond market?". *Economic Policy*, 24: 191–240.

[24] De Grauwe, P., (1996), *International Money*, Oxford: Oxford University Press, p. 27.

Although, clearly, in the economic and monetary union there is only one monetary policy and no exchange rates, first the global financial crisis and then the economic crisis made it clear to what extent the asymmetries and the 'n-1' problems that had already affected the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) persisted, and were actually much more serious, in the (EMU).

Indeed, for the 'n-1' countries joining the EMU, it meant fixing the exchange rate at a higher value than it would have otherwise been, and this is particularly true for the least competitive countries whose currencies tended to devalue more often before the establishment of the EMU—the PIIGS countries. On the other hand, the '1' country, Germany, joined the EMU enjoying a devaluation of its exchange rate which, together with the impossibility of any competitive devaluations by the other members of the EMU, progressively increased its competitiveness. What is important to underline here is that this is a structural characteristic of the EMU which was inherited from the previous exchange system but was made more serious by the fact that in the EMU there is no possibility to regain competitiveness through devaluation.

This trend is clearly visible looking at the power purchasing parity real exchange rate (RER)[25] of the PIIGS in relation to Germany based on the average consumer price index from 2000 to 2012 (Fig. 2.3).

Thus, from the start of the EMU, Germany enjoyed a structural bonus of competitiveness which increased progressively, as, indeed, had been predicted by many European Political Economy (EPE) scholars.[26] Of

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[25] The formula for the RER used here is given by:RER = e (P*/P), where e is the nominal exchange rate (1 in the case of the Eurozone), P* stands for the international prices index (in this particular case, German prices) and P is national price index. The data was obtained from the World Economic Outlook Database of September 2011, available on the IMF's website http://www.imf.org/external/pubs/ft/weo/2011/02/weodata/index.aspx. Inflation is computed with the average consumer inflation index for all countries. See http://econapproach.blogspot.it/2011/11/real-exchange-rates-and-eurozone-issues.html as accessed on December 27, 2012. For a similar analysis see European Commission, Economic and Financial Affairs (2012), Price and Cost Competitiveness, 1-2/2012, Brussels: EC, web-site: http://ec.europa.eu/economy_finance/publications/pcqr/2012/pdf/pccr_1_2_2012_en.pdf, as accessed on December 27, 2012.

[26] Talani, L.S., (2009), The future of EMU, London: Palgrave; Eichengreen, B. and Frieden, J. (1994) *The political Economy of European Monetary Union*, Boulder: Westview Press; Frieden, J. (1991) "Invested interests: the politics of national economic policies in a world of global finance", *International Organization*, 45:4, pp. 425-451; Frieden, J. (1994) *The impact of goods and capital market integration on European monetary politics*, Preliminary version, August; Frieden, J. (1998)

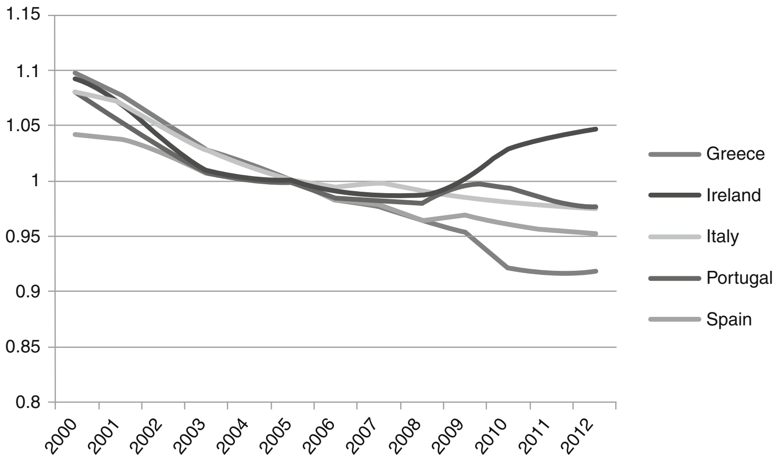

Fig. 2.3 PIIGS real exchange rates: 2000–2012 (*Source*: IMF, WEO-elaboration of the author)

course, exchange rate devaluation is considered in the economic literature as a very bad way to regain competitiveness. Much emphasis was therefore placed on what is normally referred to as 'internal devaluation', or 'supply side economics' which basically means reducing the costs of production by increasing productivity and/or reducing labour costs. Indeed, the EU approached and still approaches the whole question of growth and employment by relying significantly on labour market flexibility, the rationale of which is often neo-functionally linked to the establishment of the EMU. Furthermore, the implementation itself of flexible labour market policies was made possible by the strengthening of the bargaining power of employers' organisations, which was reflected in the institutionalisation at the European level of the neo-liberal economic paradigm focusing on the implementation of strict monetary and fiscal policies (See Talani Chap. 5 in this book).

However, despite the EU rhetoric and practice on structural reforms, these were clearly not enough to overcome the competitiveness gap

The new political economy of EMU, Oxford: Rowman and Littlefield; Moravcsik, A., (1998) *The choice for Europe*, Ithaca: Cornell University Press.

between Germany and the weakest countries of the Eurozone (See Torres and Bongardt in this book). The global financial and economic crisis led the markets to believe that the competitiveness gaps accumulated over the years between the core and the periphery of the Union was unsustainable. Indeed, Arghyrou and Kontonikas[27] argue that the performance of the spreads in the course of the global financial crisis was due to both an international risk factor, measured by the US Stock Market Implied Volatility (VIX) and a country-specific macro factor represented by the loss of international competitiveness.

In short, both the need to find a safe haven for investment in times of uncertainty and the fact that some countries' overall macroeconomic and fiscal position was judged unsustainable because of a lack of international competiveness, made the markets believe that betting against the weakest countries of the system was safe. In the lack of national exchange rates, currency speculation was obviously impossible and the markets reverted to speculation on sovereign debt, dramatically increasing the spread between the bonds of the countries under attack and the bonds of those countries which were considered stronger, primarily Germany.[28]

Summing up, more than a shelter against the worst consequences of the global financial and economic crisis, the EMU, as designed at Maastricht and implemented in the following years proved a highly asymmetric arrangement. It signalled to the markets which countries were unlikely to sustain the economic shock, thus unleashing a run on their sovereign debt.

2.5 The Saver of Last Resort: The ECB

Given the appetite of the markets for easy sources of profits, it seems inevitable that the only real rescue mechanism for the run on the PIIGS could be the European Central Bank acting as a hidden lender of last

[27] Arghyrou, M.G. and A. Kontonikas, (2010) *The EMU sovereign-debt crisis: Fundamentals, expectations and contagion*. Cardiff Economics Working Paper, N. E2010/9.

[28] Arghyrou, M.G. and A. Kontonikas, (2010) *The EMU sovereign-debt crisis: Fundamentals, expectations and contagion*. Cardiff Economics Working Paper, N. E2010/9. Monfort, A., and J.-P. Renne, (2011) *Credit and liquidity risks in Eurozone sovereign yield curves,* Paris: Banque de France Working Papers Series, n. 352.

resort and an open 'saver' of last resort. Of course, the European Central Bank is still far from becoming the official 'lender of last resort' of the Eurozone area, something that would be more than natural in a currency union. However, in the wake of the collapse of Lehman Brothers in October 2008, the ECB started a novel mode of monetary policy relying not only on conventional measures, such as interest rate cuts, but also on 'non-standard measures'. These included 'enhanced credit support (ECS)' and 'securities markets programs (SMP)'. Such measures configured a new role for the ECB as a 'hidden/modern lender of last resort' or, as referred to in some scholarly interventions as 'intermediation of last resort'.[29] The enhanced credit support relies on (a) increasing the share of liquidity supplied at its long-term refinancing operations (LTROs) relative to its regular main refinancing operations (MROs); and (b) increasing the maturity structure of its LTROs. Most importantly, all of the ECB's refinancings would be conducted on a 'fixed-rate full allotment' basis, rather than a variable rate tender format, as used before. In other words, contrary to normal practice, financial institutions are allotted the full amount of liquidity that they want at the prevailing interest rate, which was and still is very low.

Moreover, the program allowed the Eurosystem to accept assets that had become illiquid in financial markets (notably mortgage-backed securities) as collateral in its refinancing operations. In its operations, the Eurosystem provided cash loans against the security of these assets. Finally, the Eurosystem increased the number of counterparties eligible for Eurosystem operations from 140 to around 2000 and started protecting the counterparties' anonymity to avoid domino effects.[30]

Since 2008, the ECB has successively introduced six-month, twelve-month and thirty six-month terms for LTRO finance. Each of these new issues has been heavily subscribed, with Eurozone periphery banks in Ireland, Italy, Spain and Greece taking the majority of the first thirty six-month issue in late 2011. The second thirty six-month issue was in

[29] Giannone, D., Lenza, Michele, Pill, Huwand Reichlin, Lucrezia (2011), *Non-Standard Monetary Policy Measures And Monetary Developments,* Brussels: ECB Working Paper Series No 1290.

[30] Giannone, D., Lenza, Michele, Pill, Huwand Reichlin, Lucrezia (2011), *Non-Standard Monetary Policy Measures And Monetary Developments,* Brussels: ECB Working Paper Series No 1290.

February 2012 and this one was also very successful with weaker Eurozone banks.[31]

In addition, in May 2009 the ECB announced a first €60 billion Covered Bond Purchase Programme (CBPP) to purchase euro-denominated covered bonds issued in the Euro Area over the period until June 2010. A CBPP2 started in November 2011.[32]

The second non-standard component of the ECB's response to the crisis, together with enhanced credit support measures, was the launch in May 2010 of the Securities Markets Programme (SMP). This allowed the Eurosystem to buy both private and public Euro Area debt. Given the constraints of the provisions of the Treaty on the Functioning of the European Union, Eurosystem purchases of government bonds were strictly limited to secondary markets and fully sterilised by conducting liquidity-absorbing operations. They were also capped to a weekly limit which made the appetite of the markets even greater as they knew that by overcoming the limit by just a tiny bit they could make a huge profit. However, Draghi's announcement on 6 September 2012 that the SMP was superseded by the Outright Monetary Transactions (OMT) allowing for the unlimited purchase of bonds of struggling countries in secondary markets finally stopped the financial markets from going short on the sovereign debt of the PIIGS. The ECB finally became the 'saver of last resort' by making it impossible for market speculation to run against the weakest Eurozone countries' sovereign debt. Of course, this is subject to conditionality, which implies that member states willing to benefit from the OMT have to agree to the implementation of a full or precautionary ESM macroeconomic adjustment programme. Also, the International Monetary Fund (IMF) should be involved in the elaboration and monitoring of country-specific conditionality. Moreover, the Governing Council of the ECB maintains the right to initiate, continue and terminate OMT with full discretion.[33] In addition to these measures,

[31] See Financial Times available at http://lexicon.ft.com/Term?term=long_term-refinancing-operation-_-LTRO as accessed on October 18th, 2012.

[32] See ECB monetary policy online, available at http://www.ecb.int/mopo/html/index.en.htm as accessed on October 18th, 2012.

[33] See ECB online, available at: http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html as accessed on October 24th, 2012.

the Eurosystem continues to provide liquidity in foreign currencies, most notably in US dollars.[34]

Most tellingly, however, after Draghi's announcement there was no need to actually implement the OMT as the markets stopped being able to make money going short on the PIIGS' sovereign debt. The run on the PIIGS stopped, although their fiscal stances are not necessarily better than when the Eurozone sovereign debt crisis first started.

The quantitative easing (QE) programme inaugurated by the ECB on 22 January, 2015 putting 60bn euros into the system a month until at least September 2016 is, on the contrary, mainly aimed at stopping deflation, not the markets from attacking the fiscal debt of the weakest Eurozone countries.[35]

2.6 A New Economic Governance System for the Eurozone?

Given the structural issues characterising the Eurozone crisis, the need for an integrated European economic governance has been advocated on a number of occasions and, in theory, enjoys the support of leading EU politicians.[36] At the European level, however, to date there is nothing like a pan-European regulatory regime for the EU and Eurozone banking and financial systems and even less likely is the prospect of a truly common fiscal policy.

[34] For a chronological listing of the measures see the Annex "Chronology of monetary policy measures of the Eurosystem" in the November 2011 Monthly Bulletin, available at http://www.ecb.int/pub/pdf/mobu/mb201111en.pdf?7e572425fb17ac05bf95689a50691ef3and for details on the ECB's non-standard measures, including a comparison with the Fed and the Bank of Japan, see "IV. The ECB's response to the financial crisis" of the former President Trichet's speech "The ECB's enhanced credit support" available at http://www.ecb.int/press/key/date/2009/html/sp090713.en.html. For details on the ECB's response to the financial crisis, see the article "The ECB's response to the financial crisis" in the October 2010 Monthly Bulletin, available at http://www.ecb.int/pub/pdf/other/art1_mb201010en_pp59-74en.pdf. For details on the ECB's response to the sovereign debt crisis, see September 2011 Monthly Bulletin, Box 5, available at http://www.ecb.int/pub/pdf/other/box5_mb201109en.pdf.

[35] See BBC web-site http://www.bbc.co.uk/news/business-30915210 as accessed on October 22, 2015.

[36] See *Financial Times*, various issues.

Of course, some steps were taken to restructure what had proved to be a highly inadequate European regulatory regime for the financial and banking sector. In terms of the redefinition of the EU approach to the regulation of the single financial market, shortly after the onset of the financial crisis in 2008 the EU Commission President Barroso gathered a group of high profile experts, headed by Jacques de Larosière, to propose a new, integrated European system of supervision. On 25 February, 2009 the group presented a report which represented the basis for the new European financial supervisory architecture proposed by the Commission in its Communication to the Spring European Council of March 2009. Further details on the Commission's plan were contained in its Communication of May 2009. These included:

1. The establishment of a European System of Financial Supervisors (ESFS) composed of a network of national financial supervisors working in cooperation with new European Supervisory Authorities (ESAs). The latter should have been created by transforming the existing European supervisory committees (Committee of European Banking Supervisors [CEBS], Committee of European Insurance and Occupational Pensions Supervisors [CEIOPS] and Committee of European Securities Regulators [CESR]) into a European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA), respectively.
2. The establishment of a European Systemic Risk Board (ESRB), in charge of macrosupervision of financial stability to be effected by providing an early warning of system-wide risks. This was to be accompanied by the ability, if necessary, to issue recommendations to act against similar risks.

These proposals were discussed in the course of two open meetings. The first one, from 10 March to 10 April 2009, followed the report of the de Larosière group and the publication of a Commission Communication on 4 March, 2009. It informed the Commission Communication on Financial Supervision in Europe published on 27 May, 2009.[37]

In the second one, from 27 May to 15 July, 2009, the Commission invited all interested parties to comment on the more detailed reforms presented in the May Communication on Financial Supervision in Europe. At this stage there seemed to be a great deal of support for the proposed ESRB and ESFS.

The transformation of the existing Committee of European Banking supervisors on 1 January, 2011 into the European Banking Authority (EBA) based in London, and the establishment of the European Securities and Markets Authority (ESMA) in Paris and the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt created the new European Supervisory Authorities (ESAs) to be inserted in the European System of Financial Supervisors (ESFS). However, this does not seem to have substantially resolved the issue of pan-European banking and financial supervision.[38] National authorities remain responsible for the day-to-day supervision of individual firms, with the new European architecture only providing an overarching European framework for financial supervision.[39] Moreover, the ESAs themselves comprise high-level representatives of all of the member states' supervisory authorities under permanent chairmanships.[40] They have the power to temporarily ban certain high-risk financial products and activities, such as naked short selling, as well as instructing banks and other financial actors in crisis situations, drawing up standards for national regulators and settling disagreements between them.[41] However, this will be possible only in situations of

[37] A summary of the public submissions received can be found on: http://ec.Europa.eu/internal_market/consultations/docs/2009/fin_supervision/summary_en.pdf.

[38] Teixeira, P.G., (2011), "The regulation of the European Financial Market after the crisis", in Della Porta, P., and Talani, L.S., (eds), *Europe and the Financial Crisis*, London: Palgrave.

[39] For more details see http://www.consilium.Europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117747.pdf as accessed on December 21, 2010.

[40] For more details see http://ec.Europa.eu/internal_market/consultations/docs/2009/fin_supervision_may/replies_summary_en.pdf and http://ec.Europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_501_en.pdf As accessed on December 21, 2010.

[41] For more details see http://www.time.com/time/world/article/0,8599,2016359,00.html as accessed on December 21, 2010.

emergency to be defined by the council and it is limited by a safeguard clause attributing to the member states the power not to abide by the decisions of the ESAs.[42]

As in the Commission's plan, the new ESAs are complemented by a group connected to the Frankfurt-based European Central Bank, called the European Systemic Risk Board (ESRB). The ESRB monitors the risk of major threats to the economy, such as problems at major banks or asset bubbles.[43] Although connected to the ECB, the ESRB seems to be mainly a consultative body.

Given the shortcomings of these reforms to the EU banking supervision regime, made evident by the evolution of the Eurozone sovereign debt crisis, at the end of June 2012 the European Union leaders agreed to set up a single supervisory authority to oversee 6,000 banks in Europe, with the aim of having it in place by the end of the year.[44] The possibility of moving towards the establishment of a European banking union was supported by the European Council in its June 2012 summit.

Following this, the European Commission presented, on 12 September, three documents concerning the European Banking Union. The first was a communication proposing a general outline for a banking union, including the provision of a single rulebook and single supervisory mechanism (SSM), as well as foreseeing the establishment of a single bank resolution mechanism (SRM). The second was the proposal of a Council regulation that would allow the European Central Bank (ECB) to activate its formal role as the only supervisor of all banks in the Euro Area, providing for the option for non-Euro Area countries to enter this arrangement on a voluntary basis. Finally, the Commission proposed a regulation of the European Parliament and of the Council which would adapt the regulation of the European Banking Authority (EBA) to the new banking supervisory regime. This was intended to avoid problems of

[42] For more details see: http://ec.Europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_501_en.pdf as accessed on December 21, 2010.

[43] For more details see http://www.consilium.Europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117747.pdf as accessed on December 21, 2010.

[44] For the full report on the characteristics of the proposed European Banking Union see Sapir et al. (2012).

competence between the ECB and the EBA which would then remain in charge of maintaining the integrity of the Single Market.[45]

With these documents the Commission supported the idea of a European banking union that should be 'composed of a single supervision mechanism, a European deposit insurance scheme and a common resolution system'.[46]

The European Council conclusions on completing the EMU that were adopted on 18 October, 2012 reiterated the need to move towards an integrated financial framework and invited legislators to proceed with work on the legislative proposals on the Single Supervisory Mechanism (SSM) indicating the 1st of January 2013 as the deadline to agree on the legislative framework. The definition of the legislation needed for its operational implementation took place in the course of 2013. Eventually, the Single Supervisory Mechanism entered into force on 4 November, 2014 giving to the ECB the capacity to supervise around 6,000 banks in the Eurozone and in any other EU country deciding to adhere to the SSM. However, the ECB only supervises the bigger banks, while supervision for domestic banks still remains in the hands of the national central banks.[47]

Finally, on 30 July, 2014, one year after the Commission presented a proposal, the regulation establishing the Single Resolution Mechanism (SRM) for the Banking Union was published in the *Official Journal of the EU* to enter into force on the 1st of January 2016. The SRM simply implements for the Eurozone the rules already set by the Bank Recovery and Resolution Directive (BRRD) for the EU 28, allowing for the efficient resolution of both cross border and domestic banks.[48]

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[45] For the text of the three proposals see http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec1 as accessed on October 12, 2012.

[46] Sapir, A., Hellwig M., and Pagano, M. (2012), "A contribution from the Chair and Vice-Chairs of the Advisory Scientific Committee to the discussion on the European Commission's banking union proposals", in Reports of the Advisory Scientific Committee No. 2/October 2012, ESRB available at http://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_1210.pdf?490dce9cc2a2bf39b76ae4b06604b0ca accessed on October 11, 2012, p.1.

[47] See EU web-site http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm as accessed on October 22, 2015.

[48] See EU web-site http://europa.eu/rapid/midday-express-30-07-2014.htm?locale=en as accessed on October 22, 2015.

2.7 The Progress of Fiscal Coordination in the Wake of the Eurozone Crisis

The progress of fiscal coordination in the wake of the Eurozone debt crisis falls far short of a real fiscal union. This initially took the form of mainly ad hoc decisions providing for impromptu solutions lacking institutional depth and democratic legitimacy, such as the EFSF.[49] A more institutionalised rescue mechanism for member states of the Eurozone under attack by the financial markets called the European Stability Mechanism (ESM)[50] was approved in December 2010.

The Economic and Financial Ministers Council (ECOFIN) Council deliberated on the establishment of the EFSF on 9 May, 2010. The total endowment of the Fund to rescue Eurozone countries in crisis was €750 billion. This included the possibility for the EFSF to issue bonds guaranteed by Euro Area Member States (EAMS) for up to €440 billion for on-lending to EAMS in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and International Monetary Fund and to be approved by the EUROGROUP. The EFSF enjoyed a triple A credit rating awarded by the most influential agencies: Standard & Poor's, Fitch Ratings and Moody's. The EFSF was, however, only a temporary arrangement.[51]

To avoid further spreading of the sovereign debt problems to other countries, in December 2010 the European Council opted for the institutionalisation of a European Stability Mechanism (ESM), which was inaugurated in October 2012 after a long and controversial ratification process.[52] With the establishment of the ESM, the EFSF started its phasing out.

The role of the European Stability Mechanism (ESM) is similar to that of its predecessor and consists of providing financial assistance to Euro

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[49] See http://www.efsf.Europa.eu/about/index.htm as accessed on December 15, 2010.

[50] For more details, see http://www.consilium.Europa.eu/uedocs/cms_data/docs/pressdata/en/ec/118578.pdf, as accessed on December 21, 2010.

[51] See http://www.efsf.Europa.eu/about/index.htm as accessed on December 15, 2010.

[52] The ESM Treaty entered into force on 27 September, 2012. All seventeen euro area member states had ratified by 3 October, 2012.

Area member states experiencing financial problems. The funds used by the ESM to achieve its aims are raised by issuing money market instruments as well as medium- and long-term debt with maturities of up to 30 years. These assets are backed by capital provided by the EAMS according to the contribution key annexed to the ESM Treaty.[53] Whether the funds raised by the ESM would be enough to cover the refinancing needs of big EAMS in difficulty, such as Italy and Spain, and therefore stop market speculation, is debatable.[54] To be sure, the ESM is supposed to cooperate closely with the International Monetary Fund, to the extent that any EAMS requesting financial help from the ESM are expected to also address the IMF with a similar request. This is already a sign of the limited potential of this mechanism in a situation of serious crisis.[55]

In chronological terms, the last step in the EU's fiscal policy response to the Eurozone crisis has been the approval by the European Council, on 2 March, 2012 of the so-called 'Fiscal Compact' (officially the Treaty on Stability, Coordination and Governance TSCG[56]). The contracting parties agreed to keep the budgetary position of their general government balanced or in surplus. This commitment will be considered as met if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact,[57] with a lower limit of a structural deficit of 0.5 % of the

[53] See ESM website, available at http://www.esm.europa.eu/about/index.htm As accessed on October 12, 2012.

[54] See for example BBC News, available at http://www.bbc.co.uk/news/business-19870747 as accessed on October 12, 2012.

[55] See ESM website, available at http://www.esm.europa.eu/about/index.htm As accessed on October 12, 2012.

[56] For the full text see http://www.european-council.europa.eu/media/639235/st00tscg26_en12.pdf.

[57] The Stability and Growth Pact fully entered into force on 1 January 1999 and consists of a rules-based framework with both preventive and corrective elements. It initially consisted of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and the Resolution of 17 June 1997 on the Stability and Growth Pact. On 20 March 2005 the Council adopted a report entitled "Improving the implementation of the Stability and Growth Pact". The report was endorsed by the European Council in its conclusions of 22 March 2005, which stated that the report updates and complements the Stability and Growth Pact, of which it is now an integral part. On 27 June 2005 the Pact was complemented by two additional Regulations 1055/05 and 1056/05, amending the Regulations 1466/97 and 1467/97. The Stability and Growth Pact is

gross domestic product at market prices. If the ratio of the general government debt to gross domestic product at market prices is significantly below 60 % and there are low risks in terms of long-term sustainability of public finances, the lower limit of the medium-term objective specified could reach a structural deficit of at most 1.0 % of the gross domestic product at market prices. In case of significant observed deviations from the medium-term objective or the adjustment path towards it, a correction mechanism shall be triggered automatically.[58]

The fiscal pact falls short of being a real fiscal constitution for the EU, not least because the decision by the UK not to sign it has made it impossible to incorporate it into the EU Treaties, although it requires contracting parties to incorporate it into their legal systems at the constitutional level. In essence, the fiscal compact is just an intergovernmental agreement.[59] Furthermore, notwithstanding the rhetoric, the fiscal pact represents little more than a replay of the Stability and Growth Pact, apart from the reference to structural budgets which, however, is considered by the experts to be more of a complication than anything else.[60] Indeed, two things clearly limit the capacity of the Fiscal Compact to be effective: first, there are no provisions for automatic sanctions, and second,

an essential part of the macroeconomic framework of the Economic and Monetary Union, which contributes to achieving macroeconomic stability in the EU and safeguarding the sustainability of public finances. A rules-based system is the best guarantee for commitments to be enforced and for all member states to be treated equally. The two nominal anchors of the Stability and Growth Pact—the 3 % of GDP reference value for the deficit ratio and the 60 % of GDP reference value for the debt ratio—and the medium-term budgetary objectives are the centrepiece of multilateral surveillance. On 16 November 2011 and 8 November 2011, Regulations 1466/97 and 1467/97 were further amended by Regulation (EU) No 1175/2011 of the European Parliament and of the Council and Council Regulation (EU) No 1177/2011 and flanked by Regulation (EU) No 1173/2011 of the European Parliament and of the Council, which endowed the Stability and Growth Pact with effective enforcement mechanisms for Euro Area member states and on 8 November 2011, the Council adopted Directive 2011/85/EU on requirements for budgetary frameworks of the member states. While not a part of the Stability and Growth Pact, this directive is instrumental to the achievement of its objectives. See http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2012-01-24.pdf as accessed on October 20th, 2012.

[58] Full text available at http://www.european-council.europa.eu/media/639235/st00tscg26_en12.pdf, accessed October 18, 2012.

[59] De Grauwe, P., (2012), *Interview* available at :http://aregan.wordpress.com/2012/03/20/interview-with-paul-de-grauw/,accessed on October 18, 2012.

[60] De Grauwe, P., (2012), *Interview* available at :http://aregan.wordpress.com/2012/03/20/interview-with-paul-de-grauw/, accessed on October 18, 2012.

the pact allows countries to temporarily deviate from the requirements of having their budgets in balance or in surplus in case of an unusual event outside the control of the government concerned or in periods of severe economic downturn.[61]

Moreover, the pact does not include any reference to solidarity mechanisms to be activated in case of a serious crisis of one of the Euro Area member states. Although on 22 June, 2015 there was a joint declaration of the five Presidents of the EU in favour of further steps being taken in terms of integration of the Euro Area, including the establishment of a EU Treasury, these will have to be realised by 2025.[62] So there is still some time!

2.8 Conclusion

In conclusion, the burden of the costs of the crisis was inflicted on the weakest countries of the system. This was far from having been socialised among the members of the Eurozone and of the EU through the adoption of a real common fiscal policy and the attribution to the European Central Bank of its natural role as lender of last resort. It happened instead through the imposition of savage austerity plans. Indeed, the main characteristic of the EU approach to crisis management, quite apart from the rhetoric about the establishment of a new economic governance, was 'internal devaluation' with all that means in terms of pro-cyclical effects, popular resistance, political instability and eventually the threat of disruption to the EU integration process as a whole. It remains to be seen if this is a price worth paying.

[61] Full text available at http://www.european-council.europa.eu/media/639235/st00tscg26_en12.pdf, accessed October 18, 2012.

[62] See EU web-site http://europa.eu/rapid/press-release_IP-15-5240_en.htm as accessed on October 22, 2015.

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