Lessons from the European Crisis

Jürgen Stark

Two episodes in the recent past have caused crisis management in Europe to migrate to a new level. First, the establishment of a permanent funding instrument, the European Stability Mechanism (ESM), on October 9, 2012, to finance crisis and problem countries in the euro area. Second, the decision taken by the Governing Council of the European Central Bank at the beginning of September 2012 to purchase Italian and Spanish government bonds on the secondary market on an unlimited scale—the Outright Monetary Transactions (OMTs).

These events have completed a paradigm shift in the European Economic and Monetary Union (EMU). The financial markets and political leaders alike welcomed and applauded this sea change. So does this mean Europeans have mastered or even resolved the crisis? There is evidence that the reform process at both the national and supranational level with positive results is under way, which should not be disregarded by market participants and external observers. At the same time, it is a fact that more and more eurozone countries (Cyprus and Slovenia) now require external financial assistance. It is also true that the undertaking of necessary economic adjustments, and strict conditionality on financial assistance to the crisis countries, are bumping against barriers. With groans of "adjustment fatigue" here and moans about "bailout fatigue" there,

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the democratic systems are struggling to cope. The costs of granting additional aid to fellow member states and of prolonging the timeline for economic reforms and fiscal consolidation is placing a growing strain on the donor economies.

Crisis management, initially characterized by panicky, ad hoc decisions, has eventually contributed to calm down markets in the short run but is becoming increasingly expensive as well. The problems currently facing Europe necessitate fundamental decisions about the future of the euro area and of European integration. By definition, these fundamental decisions must transcend the piecemeal approach to crisis management and to the new institutional framework of EMU that we have seen so far.

This article outlines the Maastricht concept of EMU as a stability union, considers the policy failures that led to the crisis, describes and analyses the paradigm shift in the context of the crisis resolution measures, and raises some questions concerning the future of European integration.

The Maastricht Concept of a Stability Union

The Economic and Monetary Union constitutes Europe's highest—and most visible—degree of integration. This applies especially to monetary integration and the introduction of a single currency: the euro. No comparable degree of integration has been reached in foreign and security policy, or in justice and home affairs policy. Those policies remain largely intergovernmental despite repeated attempts to develop community-based elements. Economic and monetary union is undoubtedly a political project. But it is also the logical consequence of the European integration process, particularly the monetary completion of the Single European Market and the finalization of the monetary policy aspects that were already contained in the European Economic Community (EEC) Treaty of 1957.

Yet economic and monetary union is an asymmetric construct. For one thing, economic union and monetary union represent differing degrees of integration and harmonization. For another, EMU lacks the dimension of a political union in the sense of deeper interstate integration. Consequently, the integration of economic policy and of general policy has lagged behind monetary integration. The parallel evolution of monetary union and political union, which the then German government advocated during the negotiations on the

Maastricht Treaty, was opposed by some of its European partners. They were not prepared—for example, in fiscal policy matters—to accept further-going and more binding rules that would have impinged on national sovereignty. Nor were they ready and willing to move toward genuine common policy in other fields, such as foreign and security policy, which would likewise have entailed surrendering part of their national autonomy. Neither the Amsterdam Treaty nor the Nice and Lisbon Treaties brought any real progress on that front.

Nonetheless, the Maastricht concept of monetary union did lay a coherent, consistent, and solid foundation, with contractually agreed principles and rules, plus new procedures and instruments of economic policy coordination. The nub and the rub is the extent to which this concept has been implemented in practice.

The Maastricht blueprint envisaged the closer coordination of the member states' economic policies (Art. 119–21 of the Treaty on the Functioning of the European Union). To this end, "Broad Economic Policy Guidelines" were developed for the EU during 1993–94, containing country-specific recommendations. The aim of economic policy coordination was to attain lasting economic convergence among the member states and to maintain this following the start of Stage Three of economic and monetary union. The monitoring process was to embrace additional price and cost indices over and above the widely known convergence criteria, including the development of unit labor costs.

The fiscal rules were of a more binding nature, based on the principle of avoiding excessive budget deficits. The Treaty's provisions (Art. 126) were specified and operationalized by the Stability and Growth Pact. The Pact was intended to counterbalance the lack of political integration by underpinning monetary union with a set of specific fiscal rules. Its interlocking preventive and corrective arms defined medium-term targets for public finances and threatened sanctions in the event of noncompliance.

Another key provision of economic and monetary union is the no bailout clause (Art. 125 of the Treaty). It is predicated on the principle of the member states' national responsibility for their own political actions. Neither the Community nor any member state should be liable for commitments of another member state. Based on the assumption that only mature economies could qualify to join the monetary union and that any necessary adjustment efforts would have to be undertaken by each country on its own, the Treaty deliberately

excluded the possibility of granting financial assistance to individual states should they suffer stress owing to membership in the monetary union. The implicit assumption was that if a country were to encounter financial difficulties or even default, the necessary adjustment and any external public funding would occur outside of the eurozone.

The founding fathers of EMU were well aware of the danger that monetary union might lead to financial transfers. It was for this reason that on May 1, 1998—the day on which the countries qualifying to embark on Stage Three of EMU were chosen—the European finance ministers, at the prompting of Germany, adopted a declaration which explicitly prohibited financial transfers that might potentially arise from membership in the monetary union. This agreement was endorsed by the heads of state or government at the European Council in Cardiff in June 1998. Although such a political statement is not legally binding, it is a political declaration of intent and should at least serve as an interpretation aid.

The Maastricht Treaty, together with the Statutes of the European System of Central Banks and of the European Central Bank (ESCB/ECB-Statutes), created a solid framework for the euro area to construct a new European monetary architecture (Art. 127–33 of the Treaty). The European Central Bank (ECB) was given a clear primary mandate to maintain monetary stability. This was reinforced by making the ECB/ESCB independent of political influence. The ECB's degree of independence is very high in formal and legal terms. Its autonomy embraces personal, institutional, financial, and instrumental independence. The ECB's mandate and independence mirror the liberal precept of macroeconomic management, which prioritizes monetary stability as the bedrock of a functioning free-market economy. The Treaty (Art. 123) also prohibits the monetary financing of government entities. Hence, the Treaty and the Statutes incorporate the paradigm of "monetary predominance" over economic and fiscal policy.

This enumeration of the Maastricht principles, with a special emphasis on fiscal rules, the no bailout clause, the independence of the European Central Bank, the primacy of price stability, and the prohibition of monetary financing, shows that Maastricht is a sound and clear stability-oriented concept. The allegation that the Maastricht blueprint is flawed and that the institutional framework contains deficits is thus incorrect. What is correct is that the

Maastricht concept was never fully implemented. The real issue is, did it "fail" because it was not implemented or was not implementable? Was it perhaps too complex and too exacting for too many member states? Was too much demanded of the member states, and was this the reason why the standards were not met?

Historical examples show that the aforementioned principles and rules are essential for the smooth functioning of a monetary union. The success or failure of monetary unions has invariably hinged on the political determination and the political ability to adjust to the collective requirements of a monetary union. The Maastricht concept was based on the assumption that all parties involved—the member states, the Eurogroup, and the European Commission—would duly observe and obey the principles and rules, and that peer pressure would act as a powerful reinforcement. The responsible institutions fell at this hurdle, however. In an atmosphere of "unhealthy politeness" (Mario Monti) peer pressure gave way to "peer support."

Looking at the historical record, it can be seen that "political determination" was the crucial ingredient not only for the creation of monetary unions but also for their success. In particular, the signatories needed to agree clearly on the fiscal policy implications of a common monetary policy. Two dimensions of political determination are relevant here. Either the parties involved accept the dominance of one partner, a hegemon, which ensures that the agreed rules are observed, or else the contracting parties enter into mutual obligations in the form of institutional agreements with a view to reducing the free-rider risk.

What Went Wrong?

The constituent principles of economic and monetary union were not only interpreted loosely, they were disregarded. Both the general regulatory principles and the specific fiscal rules were interpreted by a majority of the political actors and commentators as flexible formulas, and not as overriding institutional rules. However, principles and rules designed to serve as the guidelines for political action at all times, and not just during political honeymoons and economic booms, were felt to be a straitjacket constricting policymakers' freedom of action. But it is precisely in turbulent times that principles should provide a medium-term orientation and protect the political actors from undesired and unintended consequences.

Today Europe is the focus of international attention. According to market participants, policymakers, and academics across the globe, it is open to doubt whether the European decisionmakers will manage to master the current crisis. If we widen the angle of vision, however, we can see that Europe is just one part of a smoldering, unresolved global crisis. Neither the financial crisis nor the economic crisis in the Western economies have yet been overcome. This crisis will have long-term consequences, including on the level of potential growth. But it will also accelerate geopolitical and geoeconomic changes. The structural problems in many advanced economies on both sides of the Atlantic are currently being masked by rocketing government debts and ultra-loose monetary policy stances. Consequently, the global financial system and the world economy remain vulnerable. Nor should we forget that the failures and failings of the current generation of political and economic decisionmakers have piled up huge economic and financial burdens for the present and future generations.

Of one thing we may be sure: the way in which the eurozone crisis is tackled and resolved will be decisive for the future of EMU and for Europe itself, its ongoing economic development, and its role in the world. This is because the European crisis is not just a sovereign debt crisis. It has several dimensions. It is also a structural crisis of individual economies that were insufficiently prepared for the membership requirements of a monetary union, or have failed to adjust and have lost their price competitiveness. And it is a crisis, too, of European integration, marked by insufficient confidence in the institutional frameworks, coupled with the unanswerable question of their finality.

The raft of failings and failures that we have witnessed since the late 1990s can be divided into three phases: (1) the choice of member states deemed eligible to adopt the euro at the start of Stage Three of EMU and to subsequently join the enlarged eurozone, (2) the practical application of the Maastricht principles and rules following the euro's introduction, and (3) the crisis management track record since 2010.

For reasons of political expediency, certain countries were allowed to join Stage Three of monetary union even though their performance, in terms of sustainable economic and fiscal convergence, was highly questionable. The same can be said of the eurozone's enlargement from initially 10 members in 1999 to 17 today. While most of the criteria were met in formal terms, their sustainability could not be convincingly validated and assessed. In virtually all the member

states that are now in trouble, the statistical data were subject to creative accounting, and in the most extreme case the figures were simply faked. Policymakers also assumed that, in the event of adverse economic shocks, the small economic weight of some member states would not impair the economic and monetary union as a whole. Moreover, it was generally expected that the euro would act as a catalyst for economic reform. In most cases this did not happen. On the contrary, the euro acted as a protective shield against necessary economic reform.

The convergence efforts undertaken in the second half of the 1990s gave way to "convergence fatigue" after 1999. The key shortcomings during the first decade of EMU were the inadequate implementation and surveillance of the new, very demanding regime, comprising a single monetary policy, for which the ECB is responsible, alongside multiple economic policies, which are still largely a national remit. The economic policy guidelines turned out to facilitate "soft coordination." They remained more of a bureaucratic exercise. Their impact on national economic policies was small as there was no effective monitoring of economic policies. The regular reporting on the implementation of the recommendations, which the Treaty envisaged, was neglected badly.

The Stability Pact proved effective in the first years following the euro's introduction. But as soon as the Pact's fiscal rules were seriously tested for the first time, they proved ineffectual. In 2003 Germany and France more or less simultaneously recorded an excessive fiscal deficit of more than 3 per cent of GDP. When the next stage of the deficit procedure was to be triggered, which entailed the possibility of sanctions further down the line, the two countries refused to accept the contractual consequences. This blatant breach of the Stability Pact's provisions effectively killed it. Motivated by short-term political thinking, the politicians feared having their radius of fiscal policy action squeezed by such external constraints, which they perceived as undermining their national sovereignty. Yet, had fiscal sovereignty not already been constrained by the Maastricht Treaty's ratification by the national parliaments and the endorsement of the Stability Pact? At any rate, the Pact's underlying rationale of offsetting the monetary union's lack of political integration by putting in place a sturdy fiscal framework was knocked on the head. The subsequent reform of the Pact in 2005 merely underscored the ineffectiveness of the rules.

Most of the member states had not really grasped the practical implications of a single currency for their fiscal and economic policies. While the political elites were aware of the possible problems, they happily traded them off against the expectation that, once they had the euro, all their fiscal and economic problems would be solved. This expectation was based on their confidence of being able to politically pressure the ECB to pursue a lax monetary policy, tolerate a higher inflation rate, and drive down the euro's exchange rate.

How do countries in a monetary union adjust to asymmetric shocks? In the absence of nominal exchange rate flexibility vis-à-vis the other countries participating in a monetary union, adjustment has to occur via other channels. Price flexibility is important in order to let countries affected by adverse economic shocks recover by adjusting wages and relative prices in order to rebuild competitiveness. The second adjustment mechanism, cross-border factor mobility—in particular, labor mobility—helps to adjust to adverse shocks. A third adjustment mechanism is fiscal transfers. Assuming that cross-border labor mobility in the eurozone is limited and in the absence of fiscal transfers—which, by the way, would only conceal but not resolve the problems—the key adjustment mechanism in monetary union is *price and wage flexibility*. They directly impact on the real exchange rate, and thus on a country's competitiveness. In fact, wages and prices are, by definition, the only remaining component of the real exchange rate that can be adjusted in the absence of nominal exchange rate flexibility. These adjustment mechanisms were discussed at the European level in the late 1980s and early 1990s. They were ignored for a long period of time.

Yet the Delors Report—the blueprint for EMU—had highlighted the challenges of monetary union very clearly back in April 1989:

> However, an economic and monetary union could only operate on the basis of mutually consistent and sound behavior by governments and other economic agents in all member countries. In particular, uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community.

Another passage reads:

> Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive. Hence countries would have to accept that sharing a common market and a single currency area imposed political constraints.

The key point is that macroeconomic imbalances and unsustainable fiscal policies are the root cause of the crisis in the eurozone. Due to policy failures and insufficient adjustment to the new regime in a monetary union, including to significantly lower interest rates set by the ECB for the eurozone as a whole, some countries have built up significant internal and external economic imbalances during the past decade. Increases in labor compensation in some countries exceeded productivity gains by a significant margin, leading to increases in unit labor costs in excess of the eurozone average and to an erosion of competitiveness. At the same time, growth in the unregulated financial sector and unsustainably strong domestic demand growth, coupled with excessive credit growth and large increases in real estate prices, resulted in large current account deficits and high levels of public and private debt.

Many factors contributed to these developments, including unrealistically optimistic expectations about future income developments and the underestimation of credit risk by financial institutions. A key factor was that wage and income policies were not sufficiently geared toward preserving competitiveness in a monetary union. Governments failed to address structural rigidities in the eurozone economies—relating, among other things, to wage-setting institutions, including wage indexation, and to labor and product market regulation. In countries with excessive credit growth and real estate price inflation, governments failed to use policy instruments that are still available at the national level, namely, regulation and taxation.

Following economic excesses featuring inflation-driven—and, hence, unsustainable—economic growth in some eurozone countries, adjustments are now unavoidable. Wrong economic policies pursued in the past are now demanding painful corrections.

Paradigm Shift and Crisis Resolution

The political decisions taken in tackling the crisis have fundamentally altered the nature of monetary union and led to a paradigm shift. In the wake of a series of panicky, ad hoc decisions taken by European finance ministers and heads of state or government, the eurozone began a transformation from a stability union to a liability union. Three seminal crisis management decisions were taken in the spring of 2010 which led to growing joint liability for the debts of the peripheral eurozone countries and, potentially, to further rising crisis resolution costs.

First, the financing of the rescue program for Greece by other member states (bailout) of May 2010, together with the program's execution inside the monetary union, infringed a central principle of the Maastricht Treaty, namely the no bailout clause, which clearly defines member states' own national responsibility for their sovereign debt.

No one disputes the fact that Greece needs an EU/IMF program. But its implementation, including the granting of financial assistance by the European partners and the International Monetary Fund, ought to have been effected outside the eurozone. The no-bailout clause clearly rules out the provision of financial assistance to a country that behaves inappropriately, and thus selfishly, in a monetary union and finds itself in trouble as a result. At most, such a country can expect support via the EU balance of payments facility, which is actually envisaged for non-eurozone states. Moreover, Greece was already insolvent in spring 2010, yet it was treated as if it were a country experiencing a short-lived liquidity problem.

Second, the creation of an initially temporary funding facility (European Financial Stability Facility or EFSF) and then of a permanent funding "mechanism" (European Stability Mechanism or ESM) for distressed countries completes the transformation to a liability union. Member states now assume liability for the debts of other countries which, in the extreme case (i.e., in the event that a country defaults or exits the monetary union) will lead de facto to financial transfers.

Third, the purchase of government bonds on the secondary market by the European Central Bank from May 10, 2010, onward infringes the prohibition of the monetary financing of government entities. Although secondary market interventions are not prohibited

per se, and the ECB justified them on monetary policy grounds, the ECB is in effect pursuing fiscal policy. Under the given circumstances, the ECB, in purchasing government bonds, is bankrolling national budgets—and thereby loading additional risks onto its balance sheet. By taking this action, the ECB is blurring the distinction between monetary policy and fiscal policy, and thus jeopardizing its independence.

The crisis management course pursued was politically justified by the risk of contagion, a threatening domino effect, and, ultimately, the danger that the EMU might disintegrate. It is true that contagion poses a potential risk, particularly in the light of the far-reaching integration that a monetary union entails. The policymakers acted, however, under the influence of a risk that was abstract and in no way concrete, let alone acute. No convincing analyses of contagion effects were presented. Policy actions were driven by mere panic.

Overcoming the crisis requires elaborating a coherent strategy and taking further integration steps toward a "political union"—a term that has always been very vague. Whereas, during the negotiations surrounding the Maastricht Treaty, the term was understood more widely to embrace a common foreign and security policy as well as a common justice and home affairs policy. In the second half of the 1990s, the Stability Pact was defined as being part of the political union. Now the talk is of supplementing the monetary union with a fiscal and banking union, and of generally aspiring to build a "genuine Economic and Monetary Union."

Overcoming the crisis involves addressing the following five points:

1. Stabilizing and reducing public debt.
2. Implementing structural reforms, in order to make the economies more flexible and more competitive as well as to strengthen potential output.
3. Reorganizing and recapitalizing the banking sector, where necessary.
4. Reforming the institutional framework of the economic and monetary union.
5. Providing sufficient liquidity to the banking sector via the ECB.

Following the panic decisions taken by the finance ministers and heads of state and government in spring 2010, these five points have

been taken up in the past two years, notably by political leaders, although inconsistently, belatedly and with differing intensity. Governments and the ECB have allowed themselves to be increasingly driven by the markets. More and more new measures were adopted, to which the markets initially reacted positively. Subsequently, some of these measures were interpreted in different ways, which prompted negative market responses. From the outset there was no comprehensive and convincing master plan for a lasting solution to the crisis, which caused tensions to escalate further and provoked uncertainty on the markets. These disparate, ad hoc decisions were declared ex post to constitute a "strategy," and they have recently been supplemented by new initiatives. This has reopened the debate on the need to move beyond monetary union, and to take further integration steps. In this unfolding drama, the ECB, as the sole truly federal European institution, allowed itself to be pushed increasingly into a crisis management role by yielding to massive international and European political pressure.

Fiscal Consolidation

The need to consolidate government budgets is indispensable. Nevertheless, the public debate on either side of the Atlantic on fiscal consolidation versus growth stimuli is being conducted very vigorously and heatedly. But this debate on austerity versus economic growth is misleading. Countries that can refinance themselves on the market only at the cost of high risk premia have no other option than to return their public finances to a sound path. Moreover, it should be remembered that, first, only a very few problem countries are considering real austerity measures. Second, the high debt levels have themselves become a barrier to growth. The political dilemma is further compounded by the fact that debt levels cannot be reduced by growth alone, and that stronger but nonsustainable growth cannot be funded by piling up even more debt. That would endanger the credit standing of more countries. What is needed is thus a reorganization of government budgets, a critical review of the scope of government activities, and a strategy that promotes structural reform in the individual economies. Fiscal consolidation and structural reform must go hand in hand.

There is a broad consensus that consolidating public finances has a positive effect on growth and employment in the longer term.

Fiscal consolidation is generally assumed to carry short-term economic costs, although one should differentiate here. For example, these short-run Keynesian costs may be very limited if, among other things, the fiscal starting position is particularly unfavorable; consolidation on the expenditure side is front-loaded, credible and consistent; and reforms are implemented that improve the long-term sustainability of public finances.

Structural Reforms

Given the longer-term negative repercussions of the financial and economic crisis on the level and growth rate of potential output, structural reforms are vital, especially on the labor and product markets. Many economies need to regain their competitiveness. In a monetary union this can only be done by adjusting wages and costs. That takes time. But structural reforms can also have a positive impact on growth in the short term by boosting confidence. However, even if structural reforms were to generate positive growth effects only in the longer run, this is no reason to put them off to the future. The long-term clock is already ticking. Although this process may be painful in many cases, it is unavoidable. It should be remembered, too, that the adjustment process in the crisis countries is being cushioned by the financial support given by their European partners and the international community.

Financial Sector Reform

A properly functioning financial sector that allocates capital efficiently is a precondition for achieving a sustained increase in output. The experience of the "lost decade" in Japan graphically highlights the potential fallout of failing to take resolute and credible action. Europe has already lost valuable time, which is partly attributable to the political taboo of letting banks fail, evident since the escalation of the financial crisis, following the collapse of Lehman Brothers in September 2008. The problems of the banking sector in continental Europe became apparent only very late on, and the consolidation of the banking sector likewise took a long time to get off the ground. This makes it all the more important to expedite reform and to recapitalize banks, if and when necessary, thoroughly and rapidly. It is key to breaking out of the vicious circle whereby concerns about

sovereign liquidity impact negatively on banking liquidity, which in turn aggravates the outlook for the sovereign. In individual cases this will only be possible through a comprehensive adjustment program, involving the provision of the requisite financial resources.

Institutional Reforms

Institutional reforms have been set in motion at the supranational level. All and any measures that help to achieve and maintain fiscal discipline, reduce internal imbalances, and avoid the emergence of new imbalances are to be welcomed. Institutional governance has been reinforced via a tightening of the Stability and Growth Pact, a new procedure for monitoring macroeconomic imbalances, and the introduction of the Fiscal Compact. In the aggregate, these measures imply a further step toward a political union. However, the main thrust of the new initiatives must be focused on reforms at the national level, specifically comprising the consolidation of public finances, structural reforms, and the restructuring of the banking system.

The governance reform is aimed at strengthening fiscal and economic governance in the EU and in particular the eurozone.[1] The main elements of the fiscal governance framework to strengthen fiscal discipline are (1) an expenditure benchmark in the preventive arm of the Stability and Growth Pact, (2) a numerical benchmark for assessing compliance with the government debt criterion in the corrective arm of the SGP, (3) new financial sanctions and nonfinancial measures for noncompliant eurozone countries that are applied at an earlier stage in the surveillance process, and (4) a higher degree of automaticity in the fiscal surveillance procedure.

The new "macroeconomic surveillance framework" is aimed at identifying and addressing macroeconomic imbalances at an early stage. The main procedural elements are (1) an early alert mechanism, comprising a scoreboard with a limited set of macroeconomic indicators and an annual assessment, (2) broad-based in-depth reviews of economic developments in member states for which significant macroeconomic imbalances or risks thereof have been identified, (3) recommendations to correct or prevent such imbalances, (4) member states can be made subject to the excessive imbalance procedure (EIP) with more detailed and stronger policy recommen-

[1]See ECB Monthly Bulletins for December 2011 and March 2012.

dation, and (5) in the event of noncompliance with the recommendations, financial sanctions can be imposed on the country concerned.

Only a few months after European institutions had formally adopted the reform of the economic governance framework (November 2011), the Fiscal Compact was agreed upon and enshrined in the new "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union" (March 2012). The new Treaty, in addition to the fiscal compact, includes provisions to foster economic policy coordination and convergence and to strengthen governance of the eurozone. The Fiscal Compact is a step toward a true "fiscal stability union" and addresses some of the shortcomings of the reinforced Stability and Growth Pact. The main elements of the fiscal compact are (1) member states' commitment to implement in their legislation, preferably at constitutional level, a balanced budget rule, (2) strengthening of the excessive deficit procedure, and (3) providing a benchmark for government debt reduction.

The new economic governance framework is an important step forward. However, the effectiveness of the reforms could be seriously weakened by the remaining degree of political discretion in executing surveillance and enforcing compliance. Furthermore, the new governance framework is extremely complex, which reduces its transparency and creates communication challenges. It is also a highly bureaucratic exercise that risks falling short of its purpose and being reduced to macroeconomic fine-tuning at the country level.

Notwithstanding the magnitude of the institutional reform and the implementation challenges, one important question remains unanswered: to what extent are institutional frameworks established during crisis times also optimal for normal steady-state periods? Policymakers in the current environment are attempting to satisfy two separate objectives in a single step, by establishing surveillance frameworks that are useful for some eurozone economies to escape from their current predicament and which also seek to prevent future crises from materializing further down the line. It is understandable that the developed framework should be conditioned by the perception of the policy mistakes that led to the current situation. However, it is worth asking whether this framework would best serve the interests of the eurozone during periods of tranquility when market pressure is less acute, and be sufficiently equipped with monitoring tools and corrective procedures that prevent a repetition not only of past mistakes but of crises of a very different nature as well.

Hence, it is absolutely vital that the framework is robust and universal.

This last point is especially relevant for the newly established permanent crisis mechanism, the European Stability Mechanism, via which crisis countries are to receive funding assistance. The very creation of the ESM suggests that policymakers have little confidence in the enhanced economic governance. If they had complete trust in the new institutional framework, they would not need a rescue mechanism which, on account of its sheer existence, will create moral hazard.

Central Bank Policy

The European Central Bank has assumed a decidedly proactive crisis management role and, in doing so, has stretched its mandate to the limit. The IMF, politicians, market players, and academics alike called for the ECB to take on an even more proactive crisis management role. They pressed the ECB to correct its "genetic defect" and step in as the lender of last resort to buy up government bonds of struggling eurozone countries—if need be on an unlimited scale—with a view of driving down the yields on these states' government bonds, which are deemed to be too high.

Meanwhile the ECB has accepted this role and announced on September 6, 2012, the launch of a new program, the Outright Monetary Transactions. The interventions in the secondary market for Italian and Spanish government bonds are, however, subject to conditionality. First, these countries must implement reforms and the ESM must participate in the interventions, and, second, the monetary policy transmission mechanism must be dysfunctional. Only the second condition can be conceivably relevant for a central bank in performing its core business. The first condition should not be requested by an independent central bank which has a clear-cut mandate for the currency area as a whole. If a central bank makes its operational actions dependent on the conduct of third parties, the name of the game is no longer monetary policy but rather fiscal policy or "monetary politics."

The ECB is aiming once again—and this time on a potentially much vaster scale than hitherto—to lower individual member states' refinancing costs, which is an implicit financial transfer and also lessens the market pressure on the countries concerned. The ECB has no mandate whatsoever to make such implicit financial transfers. It has no right to protractedly interfere with market mechanisms, let alone to

seek to assume the bond market's function. What is more, such a policy would make the ECB bend and bow to the political leaders and make it extremely difficult for the ECB to reverse its nonstandard measures. In short, the new ECB program can hardly be interpreted as being in line with its mandate. For this reason it seems more appropriate to call it the "Out-of-Mandate Transactions" (OMTs).

The problems in the eurozone are not monetary phenomena that can be combated using monetary policy instruments. In fact, it is more likely that the ECB, implementing the OMTs in combination with other nonstandard measures still in place, is storing up monetary problems for the future. No one would dispute the fact that a central bank has a duty to ensure that banks do not default owing to an insufficient supply of liquidity. Liquidity measures are thus perfectly justified—subject to the proviso that the provision of liquidity should always be a short-term concept, so as to avoid distorting effects on the money/interbank markets and to ensure that the central bank does not narrow its policy options through its own actions.

The ECB must concentrate on doing what it can do best, and that is to carry out its core mandate. Any attempts to inflate its mandate divert its attention and efforts away from its primary responsibility of safeguarding price stability. This is a central bank's raison d'être—that is, the task for which it has a democratic remit and for which it is accountable to the public. Taking on extra jobs, such as playing an active role in maintaining financial stability or volunteering to become the single banking supervisor in the eurozone, inevitably entangles the European Central Bank in conflicts of interest. It is forced to choose between different political objectives. But it has no democratic mandate for that. By taking on extra tasks, the ECB is endangering its independence.

Together with the ESM, the ECB's recent decisions concerning OMTs have been interpreted as a backstop to a further escalation of the crisis. This is based on the hope that the provision of unlimited liquidity by the ECB, the ECB's role as the lender of last resort for eurozone sovereigns, and the creation of a high firewall might manage to reassure the markets. These decisions might have a short-term positive effect in calming down the markets. But will they contribute to a sustainable solution? It is an illusion to believe that flooding the markets with cash and building a towering firewall can, by themselves, end the crisis. Disruptions in the real sector and solvency problems cannot be resolved in this way. The most these measures

can do is to buy some time, but this raises the question of whether this extra time will be made use of and, if so, in what way.

Quo Vadis Europe?

In what direction will or should Europe develop? Every step toward integration in the past required intensive preparation, the political willingness and ability to focus not on today but tomorrow, the fusion of various theoretical and political approaches, and, finally, the determination "to lay the foundations of an ever closer union among the peoples of Europe" (Preamble to the Treaty on the Functioning of the European Union). However, crises have always acted also as a catalyst for further integration, without waiting for a long-term concept to evolve, let alone waiting until the integration process has been finalized. The players acted according to the "Monnet method" of proceeding pragmatically and making the attainable steps "binding."

The political tensions within the EU and the eurozone, a changing political landscape, and growing economic and fiscal heterogeneity among the eurozone member states make it harder than before to agree on the next integration steps. This may explain the piecemeal approach followed since the panic decisions taken in spring 2010. But not only does this weaken the role of Europe in the world and the exemplary role that European integration had for other regions; it could also snowball into a serious risk of disintegration.

The *institutional reforms* that completed a paradigm shift in economic and monetary union from 2010 onward have an intergovernmental character. The knee-jerk policy reactions of the past two years are leading, via a road that bypasses the Maastricht concept, to the emergence of a new order with unknown and unknowable repercussions for the future. There may be unintended or undesirable consequences, which sow the seeds of new conflicts or crises. What is more, there is no guarantee that, despite all enhancing and enforcing of the new rules, there will not be renewed infringements that remain unpenalized. For this reason alone, Europe has to take a further step forward toward integration, which requires a clear political orientation. The current debate about a fiscal union, banking union, and a "genuine Economic and Monetary Union" demonstrates that the policymakers intend to muddle on with their piecemeal approach.

The creation of a *fiscal union* would undoubtedly constitute an important step in the direction of a political union. There are,

however, a wide array of opinions and definitions as to what a fiscal union should look like. A fiscal union should be understood neither as an oversized European budget with its own EU taxes, nor as the full harmonization of the member states' revenue and expenditure structures. Also the idea to create a separate eurozone budget can only be interpreted as an instrument for financial transfers or financial redistribution across Europe. Anyway, a fiscal union has to be put into a broader perspective of the future of European integration.

A fiscal union should relate exclusively to the institutional framework. While the Fiscal Compact points in this direction, it does not go far enough. In the light of past experience since 1998, including the year 2003, and especially during the crisis, there is clearly a pressing need for extensive supranational powers of intervention in national procedures in order to secure the fiscal discipline required in a monetary union. This requires as a first step setting up a new European institution, the European Budget Office, made up of independent experts. This Office should deal with the member states' budget plans and with the assumptions on which the medium-term fiscal plans are based, monitor budget implementation, and envisage at a later stage direct powers of intervention in the national budget processes. The findings of the Budget Office should be made available to the European Commission, the Eurogroup, and the general public, and it should be entitled to make recommendations to the Commission and Council. This could rejuvenate peer pressure and encourage ministers—emboldened by the findings of the Budget Office—to adopt a critical stance. It could or would form the nucleus of a European Finance Ministry with powers to interfere in national decisionmaking procedures as a second step.

The concept of a *banking union* (or financial market union) is likewise an omnibus term for a range of disparate ideas. Currently there are three elements of a banking union under discussion: (1) the creation of a central European banking supervision, (2) a European resolution regime, which would have to be provided with sufficient financial resources to facilitate the reorganization or liquidation of banks, and (3) a common deposit insurance scheme. The idea is to break the nexus between banks and sovereigns in order to make the eurozone more stable. Indeed, those inter-linkages have been enhanced since the end of 2011, when the ECB provided long-term refinancing to the banking system, and banks in Italy and Spain were pushed via "moral suasion" to buy Italian and Spanish government bonds. Against the backdrop of

those actions, a banking union is the logical next step, mutualizing bank balance sheet problems and country problems.

A banking union may be instrumental in regaining confidence in the eurozone. However, this will depend on its design—and, as always, the devil is in the details. Apart from the recent political decision to task the ECB in supervising the largest banks in the eurozone, many procedural, organizational, technical, and political questions still have to be answered and cannot be answered hastily. A central European banking supervision makes sense for banks with cross-border activities. However, whether a central supervisor would have prevented the banking risks in individual countries or have identified them earlier is open to doubt. There is also a critical view on the idea to task the ECB with the new supervisory role. In order to avoid possible conflicts of interest between monetary policy and the possible new responsibility, this task should not be exercised by the ECB.

Much attention has focused on the proposal for a resolution fund, which would point to joint liability and financial transfers. One issue in this respect is the legacy assets and how these assets have to be dealt with. Apart from this specific point the question arises whether a resolution fund to mutualize risks is really needed. Cannot burden-sharing agreements between the governments of the countries in which a distressed bank operates suffice? At any rate, new governance issues will need to be addressed before further integration steps on this issue can be taken.

If the decisionmakers desire a renewed thrust toward integration, they must lay down a clear *political roadmap* showing the direction, dimension, and timeline. Moreover, the next integration step needs to go beyond the economic and monetary union and incorporate other policy fields. This will necessitate both key political decisions and a broad public debate, since the general acceptance of the European idea and political credibility both suffer if top-down decisions are taken without properly informing and educating the general public about the implications.

The key decisions required for a coherent strategy to arrive at a new integration step in Europe chiefly relate to the following aspects:

- What is necessary, politically desired, and possible for deeper integration?
- In which policy fields, to what extent, and within what timeframe is a transfer of sovereignty to the supranational level possible?

- Is a multispeed Europe necessary and possible?
- Should the European Union be expanded into a fully fledged liability and transfer union?
- Should and can the current federation of states evolve into a federal state?
- How can the integration process be democratically controlled within the framework of parliamentary rights at both the European and national level?

These are some of the questions that would need to be answered in the context of a comprehensive concept to reform the EU, and which would take us along the road toward a European constitution. The responsibility for drawing up a new Union treaty—or a European constitution—should be assigned to an intergovernmental conference or a convent.

The immediate priority, however, must be to overcome the current crisis and to cement the degree of integration achieved to date. This involves maintaining the core of the monetary union. For the existence of the euro will not be endangered, should the eurozone undergo a consolidation process, as long as the historical drivers of European unity, namely France and Germany, stand together shoulder to shoulder. Safeguarding the degree of integration achieved so far, including the single currency, is the basis for taking further steps.

Conclusion

While the rest of the world has its eyes focused on Europe at the moment, the crisis in the eurozone is but part of an unresolved financial, economic, and sovereign debt crisis of the Western economies in general. It is of course compounded by causes specific to Europe: the disregarding of the principles and rules of the economic and monetary union, the lack of political determination to accept the political constraints imposed by the logic of a monetary union, and incoherent crisis management.

Europe has not prevented the crisis from escalating since 2010, but it has made progress in tackling the crisis. The panic decisions taken in spring 2010 were a lurch in the wrong direction. Key elements of the Maastricht Treaty were undermined by intergovernmental treaties, all of which has ushered in a paradigm shift. Reforms at national level remain the key to overcoming the current crisis.

Painful surgery is unavoidable after false economic policies were pursued for decades, countries lived for too long above their means, necessary reforms were put off, and accumulating problems were deliberately ignored. These reforms are in the best interests of the countries concerned. They must now make strenuous efforts to successfully implement this adjustment process. In return, they are receiving European and international assistance.

Despite this critical view on the paradigm shift and the piecemeal approach in crisis management, eventually a concept has emerged with a comprehensive reform agenda. Actions are being taken to strengthen the eurozone foundations. These actions show that progress has been made in addressing the fundamental causes of the crisis. Strong fiscal consolidation, wage adjustments, and addressing internal imbalances are quite an achievement in an international context.

The reforms at the supranational level reflect the need for deeper integration. However, the new institutional framework is extremely complex and highly bureaucratic. Is it robust and universe? Is it optimal for normal steady-state periods? To what extent will the new permanent ESM create moral hazard? Will it lead automatically to a fully fledged liability and transfer union? There remain unknown and unknowable repercussions for the future.

For this reason a clear political orientation is necessary. Policymakers must lay down a clear political roadmap showing the direction, dimension, and timeline of the next significant integration step. This will inevitably impinge on national sovereignty, which, in turn, highlights the need for a coherent and cogent master plan with the goal of agreeing to a European constitution.

The euro and the economic and monetary union do have a future. After more than 60 years of successful European integration, which, however, was continually interrupted by jolts and setbacks, the need now is to secure the level of integration achieved to date. Europe must prove that it is capable of reform. The crisis has led along a very difficult and painful path to reforms.