Ca' Foscari
University
of Venice

Master's Degree Programme

Second Cycle
(ex. D.M. 270/2004)

in

Comparative International Relations

Final Thesis

From Coal and Steel Community to Eurozone: An imperfect economic integration

Supervisor
Ch. Prof. Giovanni Favero

Assistant supervisor
Ch. Prof. Duccio Basosi

Graduand
Isabel Cavalli
Matriculation Number 848778

Academic Year
2017/2018

«Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity».

Robert Schuman, Declaration of the 9th May 1950

ITALIAN ABSTRACT

L'integrazione europea, postuma alle due guerre mondiali, rappresenta indiscutibilmente la più incredibile forma di cooperazione nella storia, se non dell'umanità, almeno di quella europea, in cui due figure politiche furono sicuramente decisive: il ministro francese degli esteri, Robert Schuman e il leader francese, Jean Monnet.

Il Trattato di Parigi (1951), ratificato da sei padri fondatori (Belgio, Francia, Germania Ovest, Italia, Lussemburgo e Paesi Bassi), rappresenta il più grande successo e traguardo del ventesimo secolo che avrebbe dato vita non solo alla creazione della Comunità del Carbone e dell'Acciaio (CECA), che pose enormi e altissime aspettative per una solida integrazione economica, ma a un periodo di pace, collaborazione e cooperazione, senza precedenti e senza eguali, in cui le tensioni specialmente franco-tedesche avrebbero trovato una risoluzione.

Il contesto europeo inteso da un'ottica geopolitica, economica e sociale ha subito sicuramente degli enormi e significativi cambiamenti che sono culminati in una serie di accordi tra stati e in un sistema basato su solidarietà, coesione e volontà di riscostruire un'Europa unita.

Il Trattato di Parigi è sicuramente stato il trampolino di lancio che ha visto decollare progetti non solo politici ma soprattutto, economici. In primis, la creazione della Comunità Economica Europea (CEE), con la ratificazione del Trattato di Roma (1957), su suggerimento dello *Spaak Report,* volto a promuovere un primordiale mercato unico e un'unione doganale, tra i sei paesi fondatori, il cui successo fu segnato da un vero e proprio boom europeo dettato da un mercato fiorente, una prosperità commerciale e una solida crescita industriale, tra il 1958 e il 1965. In secundis, il lancio del Mercato Unico Europeo (MUE), nel 1986, suggerito dall'ex Presidente della Commissione Europea, Jacques Delors, in quale intendeva rilanciare il progetto europeo, completando il mercato interno, dopo un periodo di grande stagnazione politica, tra gli anni 70-80, segnato dall'*Europessimismo* e dall'*Eurosclerosi*.

Il MUE fu, infatti, fondamentale sia per il livello di armonizzazione e liberalizzazione del commercio che venne raggiunto ma soprattutto, per il nuovo approccio cooperativo-politico che pose le basi e le premesse per spingersi fino al lancio di un'unione monetaria.

Tuttavia, è il Trattato di Maastricht (1992), sulle scie del *Delors Report,* a sancire una grande svolta decisiva e un cambiamento ambizioso che segnerà sicuramente l'inizio di una nuova era europea verso una vera e propria *Europeizzazione*, volta a una centralizzazione della sovranità monetaria.

Il lancio di un'Unione Economica Monetaria (UEM), con la creazione di una moneta unica, l'Euro, stagnava già nei cuori e nelle menti dei leader europei dal 1969 quando l'Europa e il sistema internazionale furono sconvolti da instabilità e svalutazioni monetarie. Fu proprio in questo contesto che prima il *Werner Report* (1970) e successivamente la creazione di un Sistema Monetario Europeo (SME), nel 1979, come risposta allo smantellamento di Bretton Woods con l'annuncio del Presidente Americano, Richard Nixon, il 6 agosto 1971, trovarono terreno.

Lo SME, creato proprio per preservare la stabilità dei tassi di cambio e per contenere le fluttuazioni, porrà le basi per l'odierna Eurozona. All'interno di questo sistema, il ruolo giocato dalla Germania, dalla Bundesbank e dal marco tedesco hanno avuto sicuramente un peso da non sottovalutare. Tuttavia, il lancio effettivo di un'unione monetaria dovette aspettare la fine degli anni '90, in seguito a uno scenario politico totalmente diverso rispetto a quello degli anni '70, colpito allora da instabilità e speculazioni e soprattutto, da una vera e propria reticenza nel concedere una certa sovranità nazionale.

La creazione della UEM fu il risultato di lunghe e complesse trattative, al centro di un vero e proprio dibattito ideologico già presente all'epoca di Werner nel contesto del Den Haag Summit (1969), tra *economisti* e *monetaristi*, concordi però nel ritenere che l'integrazione economica avrebbe portato alla creazione di una blocco economico-monetario, credibile a livello internazionale e unito a livello europeo, nonché alla risoluzione delle instabilità nei tassi di cambio e al pieno sfruttamento dei benefici derivanti dal Mercato Unico. Quest'ultimo, già a partire dal 1988 grazie alla Direttiva 88/361/EEC, poteva godere di un mercato privo di controlli sui capitali.

Dando il giusto merito a quello che fu il *Werner Report* (1970), il *Delors Report* (1989) redatto dal precedente Presidente della Commissione europea, Jacques Delors, delineò delle linee-guida da seguire in tre fasi cruciali, prima di rinunciare alla moneta nazionale.

Con l'intento di assicurare un adeguato processo di valutazione per l'adozione dell'Euro, a partite dal 1° Gennaio 1999, agli stati fu richiesto di soddisfare dei requisiti imposti dai Criteri di Convergenza, stabiliti a Maastricht. Tuttavia, essendo basati su una convergenza nominale e non reale, i criteri si focalizzarono su fattori non necessari per la creazione di un'area valutaria ottimale, se si considera l'effettiva teoria di Robert Mundell. Trascurando quindi le condizioni richieste, venne condotta un'analisi incongruente e inappropriata, ulteriormente aggravata da un'eccessiva flessibilità nell'interpretazione dei criteri, inizialmente ritenuti fattori assoluti, su richiesta della Germania, per dimostrare credibilità e stabilità.

Spinti da un eccessivo entusiasmo e dall'ottimismo di creare un'Europa, in questo caso un'Eurozona solida, che avrebbe permesso, almeno nell'immaginario dei leader europei, stabilità macroeconomica, prosperità, crescita, progresso sociale ed economico e infine occupazione; il merito economico fu accantonato e i criteri di convergenza ignorati, includendo stati che non soddisfavano nemmeno i criteri scelti ma che volevano essere partecipi di questo passo tanto ambizioso quanto irreversibile.

Stati come Regno Unito e Danimarca furono invece esclusi da questo progetto, attraverso le cosiddette *opt-out-clause*, essendo riluttanti a rinunciare alla propria indipendenza e sovranità monetaria in favore di una centralizzata.

La decisione di agire in questo modo è probabilmente legata alla paura di un fallimento non solo dell'Euro ma di un intero progetto europeo basato sulla cooperazione. Tuttavia, sottovalutando le conseguenze di questa decisione, inizialmente undici stati (e attualmente diciannove) si unirono a un progetto tanto imperfetto quanto incompleto, costruito attorno a una Banca Centrale Europea creata sul modello tedesco della Bundesbank, il cui mandato pone come obiettivo primario la stabilità dei prezzi,

intesa come «*close but below to 2%*» e vincolata a parametri fiscali stabiliti dal Patto di Stabilità e Crescita (1997), esteso anche agli stati membri dell'Unione Europea, che impone dei vincoli eccessivamente restrittivi per le economie europee eterogenee - un debito al di sotto del 60% e un deficit al 3%, sulla base della ''*regola d'oro''* tedesca – e che accentua un effetto pro-ciclico delle politiche fiscali poiché applicata sia in momenti di ripresa che di flessione economica.

Ad aggravare l'iniziale situazione, gli stati furono espropriati di un prestatore di ultima istanza ma soprattutto, di un qualsiasi meccanismo automatico di stabilizzazione, in assenza di tasso di cambio, ormai ancorato all'Euro, e di politiche fiscali libere di soddisfare le vere esigenze economiche nazionali.

Creando un sistema ibrido, affetto da una centralizzazione monetaria e una decentralizzazione fiscale, un dissesto economico europeo è stato inevitabile, aggravato non solo da una politica monetaria asimmetrica e ambigua che, in alcuni casi, ha pure commesso degli errori imperdonabili sottovalutando segni evidenti di instabilità finanziaria; ma anche da politiche fiscali inefficienti e incapaci di esercitare una forza controciclica, *ove necessario*.

In un modo o nell'altro, alcune categorie di stati sono state avvantaggiate rispetto ad altri in cui una frammentazione interna, una crescente divergenza e infine, gravi sbilanci macroeconomici sono venuti alla luce. Da un lato, sono comparsi i *Core countries*, che hanno beneficiato di un ruolo economico sempre più prominente e competitivo grazie a una svalutazione interna dei salari e dall'altro, i *Periphery countries*, che hanno sofferto e continuano a soffrire di un ruolo competitivo sempre più deteriorato, una crescita economica sempre più fievole e di deficit e debiti sempre più alti.

Dal lancio dell'Euro, la performance dell'Eurozona è stata meno promettente di quanto sperato, dovuto in parte alle rigidità fiscali e monetarie ma soprattutto, alle enormi differenze strutturali ed economiche tra stati membri. In questo modo, l'Euro e la creazione di un'Unione Economica Monetaria sembrano aver, in realtà, accentuato le eterogeneità in termine di competitività, tassi di occupazione e di impatto di recessioni e di crisi. Soprattutto, non hanno garantito le tanto promesse mobilità dei lavoratori e la tanto decantata crescita.

Nonostante l'Eurozona sia ora afflitta da una *stagnazione secolare*, con una produttività e una crescita bassissimi e livelli di disoccupazione e di disuguaglianza particolarmente elevati, l'integrazione dei mercati finanziari e i movimenti di capitali sono cresciuti notevolmente con effetti destabilizzanti, dovuti a tassi di interesse inferiori a quelli a cui certi stati sarebbero stati esposti, se non fosse stato per l'Euro che ha contribuito ad accrescere la loro credibilità.

Piuttosto che risolvere le divergenze e assorbire gli shocks asimmetrici, il flusso di capitali dai *Core countries* (come Germania e Francia) ai *Periphery countries* (Grecia, Spagna e Irlanda) ha contribuito a creare delle vere e proprie bolle in alcuni settori privati, come quello immobiliare ed edile, e a fomentare un vero e proprio sperpero nel settore pubblico.

La vastità dei capitali tra il 2000 e il 2008, che comunque doveva già essere un evidente segno allarmante e un indicatore di asimmetrie piuttosto che un sintomo di convergenza, avrebbe dovuto

allarmare già allora la Banca Centrale Europea, che avrebbe potuto agire prontamente. In questo contesto, i *Periphery countries* poterono cosi godere di un vero e proprio *easy credit* (credito agevolato) che andò proprio a promuovere una crescita esplosiva che prima o poi, avrebbe manifestato conseguenze catastrofiche.

Con il fallimento di Lehman Brothers nel 2008 che sconvolse l'intero sistema finanziario internazionale e l'interruzione di questo enorme flusso di capitale all'interno dell'Eurozona, già indebolita dalla sua struttura imperfetta, una pressione bancaria e finanziaria nei paesi dell'Eurozona fu tale da quasi determinare un vero e proprio *collasso finanziario*.

L'Ottobre 2009 verrà sicuramente ricordato come ''l'inizio della fine'' che diede origine alla *Grande Depressione*, i cui effetti furono talmente esorbitanti da piegare in ginocchio non solo la Grecia, il primo stato a dichiarare la reale situazione economica interna, ma l'intera Eurozona. Quest'ultima fu sconvolta da una vera e propria devastante crisi, che iniziò come liquida-bancaria e si trasformò in crisi del debito, la ora nota *crisi del debito sovrano europeo*.

La crisi non risparmiò nessuno e si propagò come un vero e proprio cancro. Non solo la disoccupazione e i debiti sovrani esplosero fino a livelli terribili, i deficit aumentarono, la crescita rallentò e i budget pubblici si deteriorarono, ma soprattutto tutte le inefficienze e le fragilità dell'Eurozona emersero, cosi come le falsificazioni delle contabilità dei singoli stati, pur di conformarsi ai parametri europei.

Seppur con grandi ritardi, la Banca Centrale Europea si attivò, prima agendo come prestatore di ultima istanza e comprando bond nel mercato secondario con l'intento di salvaguardare il canale di trasmissione della politica monetaria con l'Outright Monetary Transactions (OMT) e Securities Market Program (SMP), sulla base dell'articolo 123 TFUE, e poi, attivando finalmente nel 2015, sei anni dopo la Federal Reserve , misure non-convenzionali, come il Quantitative Easing Programme.

Sicuramente rispettando il «*whatever it takes*» del Presidente della BCE, Mario Draghi, la BCE è stata fondamentale nell'evitare un crollo finanziario europeo e nel calmare i mercati, dimostrando di essere un organo capace di evolversi. Tuttavia, se pur nell'intento di agire *within the mandate*, la BCE potrebbe avere agito eccessivamente, violando la propria indipendenza politica, se si considera l'eccessivo ruolo della Banca nella Troika, e soprattutto, nelle negoziazioni con la Grecia e il suo crescente focus sulla stabilità finanziaria, che potrebbero in qualche modo sollevare della considerazioni sulla necessità di rivedere il mandato, date le nuove competenze acquisite dalla BCE.

A partire dal 2012, i leader europei hanno concordato il lancio dell'Unione Bancaria, con l'obiettivo di rafforzare il sistema finanziario e bancario in Europa; rompere il profondo legame tra banche e debito sovrano riducendo quindi i rischi derivanti e infine, porre la supervisione delle banche sistemiche europee sotto la vigilanza centralizzata europea, attraverso il Meccanismo di Vigilanza Unico e il Meccanismo di Risoluzione Unico. Nonostante l'Unione Bancaria rappresenti un grande passo, rimane tutt'ora incompleta e, prima o poi, dovrà essere supportata da un'ulteriore elemento, ovvero un Sistema Europeo di Assicurazione dei Depositi, per garantire maggiore stabilità finanziaria,

diffondendo più fiducia reciproca e riducendo l'esposizione delle banche al debito sovrano e infine, per creare un meccanismo di *risk-sharing* all'interno dell'Eurozona e una rete di salvataggio credibile.
Tuttavia, per quanto la BCE sia stata fondamentale, gli stessi stati membri dell'Euro, si attivarono per lanciare dei veri e propri pacchetti di salvataggio, rispettivamente nel 2010, con il Fondo Europeo di Stabilità Finanziaria, e nel 2012 con il Meccanismo Europeo di Stabilità, sulla base dell'articolo 136 TFUE (amendato con il Trattato di Lisbona nel 2009), con lo scopo di garantire la stabilità finanziaria europea e fornire assistenza agli stati in difficoltà, tra cui Grecia, Irlanda, Portogallo e Spagna.
Agendo in questo modo, la credibilità dell'articolo 125 TFUE, che sancisce la cosiddetta *no-bail-out clause,* è stata messa in discussione, rischiando ora di sollevare un ulteriore problema: l'azzardo morale. Inoltre, ad aggravare la situazione e in qualche modo, ad danneggiare l'immagine dell'Unione Europea e della UEM, furono sicuramente sia le gravi condizioni imposte dall'*austerity* a paesi come la Grecia, i cui effetti furono e sono tutt'ora cosi devastanti tali da compromettere la ripresa economica del paese; sia l'iniziale intransigenza nel concedere una ristrutturazione del debito, che doveva essere concessa e dovrebbe essere garantita, quando è necessario, sotto la supervisione di un organo mediatore credibile europeo tra creditori e debitori, in modo da evitare l'eccessivo interventismo del Fondo Monetario Internazionale.
Per quanto la crisi finanziaria abbia avuto un impatto devastante, aggravato dall'*austerity* che causò una vera e propria deflazione e un'ulteriore peggioramento della crescita e occupazione, gli stati membri dell'Eurozona realizzarono che l'unione monetaria non si limita alla condivisione di un'unica moneta ma anche alla condivisione di un unico destino. Di conseguenza, un tentativo di migliorare l'attuale quadro fiscale sotto il Patto di Stabilità e Crescita è stato avanzato lanciando pacchetti e riforme come il TwoPack, SixPack e Fiscal Compact.
Per quanto siano stato fatte magari con buoni propositi, queste riforme non hanno fatto altro che introdurre nuovi target, nuove regole e nuove procedure che hanno semplicemente complicato un sistema già complesso, eccessivamente burocratico e asimmetrico. Questo sistema eccessivamente sovraregolato, con la trasposizione di *principio del pareggio di bilancio* nei sistemi nazionali e una serie di eccezioni, compromettono non solo la credibilità del sistema ma soprattutto, rendono impossibile esercitare sia politiche controcicliche che contenere gli sbilanci macroeconomici, essendo attaccati in maniera estremamente asimmetrica, con il Macroeconomic Imbalance Procedure (MIP).
Pensare che l'Eurozona giungerà prima o poi alla creazione di un'unione fiscale, esaltata come la cura a tutti i mali, è un'utopia che dovrà essere accantonata.
Il fallimento del coordinamento delle politiche fiscali, dettato da una generale insoddisfazione e unito a ostacoli legali e procedurali, pongono già sufficienti conferme che l'unione fiscale non potrà essere creata. Il risultato potrebbe essere ancora più catastrofico rischiando non solo di accentuare il malcontento e le eterogeneità ma soprattutto, di estendere un principio basato sul *one-size-fits-all* pure nel ramo fiscale.

Senza dubbio, le politiche fiscali europeo non stanno funzionando e probabilmente, una revisione in grado di offrire regole più semplici e più adeguate alle reali esigenze delle economie europee sarebbe sicuramente auspicabile.

Indiscutibilmente, l'Euro non solo ha raggiunto un sorprendente supporto tra gli stati e i cittadini, nonostante i difetti del quadro in cui si muove; ma soprattutto, è diventata una delle monete più forti a livello globali, contribuendo a creare un blocco economico, che per quanto frammentato internamente, è credibile e competitivo a livello internazionale.

Per quanto alcuni stati europei e leader europei bramino ardentemente lo smantellamento dell'Euro, si dovrebbe riconoscere, prima o poi, l'irreversibilità di tale processo dettato da due ulteriori fattori: in primis, l'impatto economico a cui le economie potrebbero sottostare causando un vero e proprio shock economico o ''*la madre delle crisi finanziarie''*, come la definisce l'economista Barry Eichengreen; e in secundis, l'assenza di un qualsiasi provvedimento o riferimento legale nei Trattati Europei, sia TFUE che TUE, essendo l'art. 50 TUE inadeguato per procedere con uno smantellamento dell'Eurozona ed applicabile esclusivamente in caso di uscita dall'Unione Europea, dato probabilmente dal profondo significato attribuito al lancio dell'Euro.

Senza dubbio, però, l'Eurozona rimane incompleta e imperfetta per quanto il valore attribuito a questa moneta sia sorprendente.

Nei quasi settant'anni di integrazione europea, gli stati hanno sempre dimostrato la loro capacità di collaborare e cooperare, nonostante qualche fallimento politico, riconoscendo talvolta gli errori commessi. Cambiare o quanto meno perfezionare gli enormi risultati raggiunti dovrebbe essere una della priorità dei leader europei. Al fine di avere un'Eurozona più efficiente, sarà, prima o poi, necessario supportare gli stati con nuovi strumenti tra cui per esempio un meccanismo di stabilizzazione europeo, in grado di rispondere alle tendenze cicliche negative, per garantire una maggiore stabilità finanziaria e supportare gli stati con un adeguata solidarietà, che in certi momenti è venuta a mancare.

In assenza di una completa mobilità di fattori, come la mobilità dei lavoratori, delle valide alternative dovranno essere trovate per risolvere la profonda divergenza sociale ed economica che affligge il sistema, altrimenti l'Eurozona rischierà di rimanere un sistema ''zoppo'' e inefficiente. Ma soprattutto, si dovrà cercare di ridurre l'altissimo livello di indebitamento che affligge diversi membri dell'Eurozona che, sicuramente, impedisce non solo una ripresa economica ma ostacola anche la crescita del paese. Infine, dovranno essere studiati dei meccanismi che garantiscano un ristrutturazione del debito, permettendo uno scambio di *bad debt* con *safe debt* e dando la giusta credibilità alla *no-bail-out-clause.* Un maggiore stabilità dell'Eurozona potrà essere raggiunta solo quando un mercato più solido e compatto sarà creato.

Garantire una maggiore supervisione dei mercati finanziari e ridurre l'eccessiva dipendenza della banche, attraverso anche altre alternative di finanziamento con la creazione di un mercato dei capitali più forte, potrebbero rendere più competitiva e stabile l'Eurozona.

ENGLISH ABSTRACT

The European integration stands undoubtedly as the most impressive and incredible form of cooperation in the European history, where two key political figures played a crucial and decisive role. These were the French Foreign Minister, Robert Schuman and the French leader, Jean Monnet, who conceived the idea of a unified Europe.

The Treaty of Paris (1951), ratified by Six Founding Members (Belgium, France, West Germany, Italy, Luxembourg and The Netherlands) emerges as the most remarkable achievement of the Twentieth century. Not only it gave birth to the European Coal and Steel Community (ECSC) but it also placed high expectations of succeeding towards a further solid economic integration and an intense period of peace, collaboration and cooperation without precedents by relying on the resolution of tensions between France and Germany.

European political, economic and social context has undergone an intense and significant number of changes, which have culminated in the establishment of bodies, treaties and institutions among member states and a system based on solidarity, cohesion and lastly, willingness of creating a unified Europe.

The Treaty of Paris has been used as a stepping stone which launched political and economic projects. On the one hand, at the suggestion of the *Spaak Report*, the European Economic Community (EEC) was created with the ratification of the Treaty of Rome (1957). This aimed at promoting a rudimentary common market and a customs union, among the six founding members, whose success has been marked by an intense economic European boom, a thriving market, an economic prosperity and an impressive industrial growth between 1958 and 1965. On the other hand, the former president of the European Commission, Jacques Delors, suggested the launching of the Single Market Program through the Single European Act (SEA) in 1986, as a way to push further and restore the European project by completing the internal market after a stagnating period, between the 1970s and 1980s, marked by very few progresses and political initiatives, also known as *Euro-pessimism* or *Eurosclerosis.*

Not only did the SEA strengthen the four freedoms (goods, services, people and capital) and ensure a level of harmonisation and a liberalisation of factors trade but is also introduced a new approach in terms of political cooperation and coordination, which even set the conditions for moving towards the launching of a monetary union.

Nonetheless, it is the Maastricht Treaty (1992), on the premises of the *Delors Report*, that marks a major breakthrough and a greater shift. Besides marking the beginning of a new European era, it stands as the most ambitious and debatable step of *Europeanization*, intended to centralise European monetary policies.

Plans for establishing an economic and monetary union and launching a single common currency, the Euro, traced back since 1969, when Europe and the international monetary system were hit by financial instabilities and monetary devaluations. In this context, the Werner Report (1970) was issued

while the European Monetary System (EMS) was created, in 1979, as a response to the dismantlement of the Bretton Wood System, which occurred on the 6th August 1971 with the announcement of the President of the United States, Richard Nixon.

The EMS was created as way for preserving exchange-rate stability and containing fluctuations where Germany, the German Bundesbank and the Deutsche Mark played an incredible role. By brilliantly succeeding in its aim, the ESM set the conditions and the premises for the current *Eurozone,* even though the effective launch of the monetary union did not arrive until the late 1990s as the political scenario was completely different from the one of the 1970s – the latter being hit by instabilities, speculations and lastly, an extreme reluctance in giving up monetary sovereignty.

The creation of the EMU is the final outcome of a long process of understanding, compromises and ideological clashes. This vivid debate between a *monetarist* (supported by France) and *economist* (supported by Germany) position traced back to the *Werner Report* (1970) over different economic policy-making and conceptions of monetary integration. Yet, both sides agreed that economic integration would have led to the creation of a credible economic-monetary block at international level and a solid-unified block at European level by solving all exchange-rate instabilities and fully exploiting benefits deriving from the creation of a Single Market, which from 1988 through the Directive 88/361/EEC could already enjoy the removal of capital controls.

By acknowledging the merits of the *Werner Report* (1970), the *Delors Report* (1989) issued by the Committee chaired by the former President of the European Commission, Jacques Delors, provided the main guidelines to be followed in crucial steps, before moving to the irreversible step: the abandonment of the national currency.

To ensure a smooth and adequate evaluation process before adopting the Euro, starting from the 1st January 1999, member states were asked to satisfy some requirements established by the Convergence Criteria, as defined in Maastricht. Yet, being based on a nominal convergence rather than a real one, those criteria focused on factors and conditions that are not necessary for creating an optimum currency area, if the theory of Robert Mundell is considered. Hence, ignoring appropriate elements and factors, an incongruent and in-adequate analysis was conducted, which was even aggravated by an excessive flexibility in interpreting the criteria, which were instead initially considered as something fixed and immutable under the pressure of Germany, for demonstrating the right credibility and commitment required.

Driven by an excess of enthusiasm and optimism in creating a more cohesive Europe and currency area, which would have promoted, at least in the minds of European leaders, macroeconomic stability, prosperity, growth, social and economic progress and lastly, employment, economic merits were set aside in favour of a more amenable approach. As a result, convergence criteria were simply ignored including also those member states that were not fulfilling the criteria chosen but wanted to be part of this ambitious and irreversible step while excluding others, such as United Kingdom and Denmark, through the *opt-out-clauses* (established in the Maastricht Treaty), which were reluctant to give up

their independence and their monetary sovereignty in favour of one centralised.

Politics won over economics due to fears of a ‘’Euro-failure’’ and of a collapse of the whole European project based on cooperation. Yet, underestimating the consequences of a similar decision, eleven member-states (now amounting to nineteen) joined an imperfect and incomplete system.

On the one hand, the monetary policy is administered by the European Central Bank (ECB), which has been modelled on the German Bundesbank and whose mandate recognises price stability, as its primary objective, with an inflation target defined as «*close but below 2%*». On the other hand, European countries are committed to numerical parameters established by the Growth and Stability Pact (1997), which is extended not only to Eurozone countries but also member states of the European Union. This Treaty dictates some thresholds that are simply too restrictive for the heterogeneous European economies: a government debt below 60% and a 3% deficit – it being based on the German ‘’*golden rule*’’. Yet, a similar approach accentuates the procyclical effect of fiscal policies since the same thresholds are applied both in economic upturns and downturns.

To worsen such situation, as soon as the Eurozone was established, states were deprived by a Lender of Last Resort (LOLR), an automatic stabilization mechanism in the absence of exchange rates now pegged to the Euro, and fiscal policies free to satisfy the real economic needs.

By creating a hybrid system, based on a monetary centralization and a fiscal decentralization, economic disorder has been unavoidable. This was further aggravated by an asymmetric and ambiguous monetary policy, that in some cases, has made unforgivable mistakes underestimating clear signals of financial instability, but also by inefficient fiscal policies that have hinder any countercyclical effect.

An internal fragmentation has become evident to the extent that two different groups have emerged: on the one hand, the «*Core countries*», benefitting from a more prominent and competitive role thanks also to internal wage devaluations and, on the other the «*Periphery countries*», suffering from a progressivly deteriorating competitiveness, weaker productivity growth and higher expanding deficits.

Since the launching of the Euro, the performance of Eurozone has been more dismal than expected, probably due to monetary and fiscal rigidities but, above all, to the structural and economic differences among member states. Hence, the Euro and the launching of an Economic and Monetary Union have rather intensified heterogeneities in terms of competitiveness, employment rates and impact of crisis and recession while it has not ensured the promised labour mobility and much-vaunted growth.

Even though the Eurozone is now affected by *a secular stagnation*, with low growth and productivity rates and high unemployment and inequalities rates, both financial markets’ integration and capital flows have been fostered with destabilizing effects, due to lower and accommodating interests rates for those states that have gained a stronger credibility by joining the Euro.

Rather than solving divergences and asymmetric shocks, the capital flow from the Core countries (Germany and France) to the Periphery Countries (Greece, Spain and Ireland) contributed to fuel financial bubbles in private sectors, such as housing and construction, and to foster a real public

profligacy.

The magnitude of cross-border financial flows between 2000 and 2008, which should have seen already as a clear indicator of asymmetries rather than a symptom of a catching-up process, should have warned by the time the European Central Bank, which should have acted promptly. Within this context, the *Periphery countries* benefitted from an *easy credit* which fostered a booming growth that, sooner or later, would have manifested its catastrophic consequences.

With the financial collapse of Lehman Brother, in 2008, that upset the international financial system, and the interruption of this immense capital flow within the Eurozone, the banking financial pressure coming from the frozen banking system in the Euro-countries was such to almost determine a real Euro's financial collapse.

October 2009 stood as a critical moment. Probably, it will be remembered as the beginning of the process which gave rise to *the Great Recession*, whose effect was exorbitant and dramatic to bend to its knees not only Greece, that was the first state to reveal its real economic situation, but the whole Eurozone. The currency area was hit by a full-blown devastating crisis that started as a liquidity and banking one and evolved into a sovereign debt one, the now well-known *Eurozone sovereign debt crisis.* The crisis did not spare any Eurozone country and rather it propagated as a cancer contaminating all European economies. Unemployment rate and debt levels exploded reaching dreadful levels, deficits augmented, growth slowed down while public deficit deteriorated. Last but not least, Eurozone weaknesses and fragilities as well as fake bookkeeping and accounting, that were masked to conform to European parameters, came to light.

Even though with some delays, the European Central Bank acted firstly as a lender of last resort by injecting a huge of quantity of liquidity and by buying government bonds in the secondary market with the aim of safeguarding an appropriate monetary policy transmission through the Outright Monetary Transactions (OMT) and the Securities Market Program (SMP), established on the basis of art. 123 TFEU and then finally activating in 2015, six years after the Federal Reserve, unconventional measures, such as the Quantitative Easing Program.

Surely, under the «*whatever it takes*» announcement of the President of the European Central Bank, Mario Draghi, the ECB has played a crucial role in avoiding an European financial collapse and calming down the market, demonstrating that this body is an evolving institution. Yet, while trying to act *within the mandate*, the ECB might have overacted, violating its political independence if one considers the excessive role of the ECB within the Troika and especially with Greece's negotiations. Similarly, being the ECB now more focused on financial stability than it used to, considerations over the need of revising its mandate might seem legitimate due to the new legal competences acquired by the ECB.

Starting from 2012, European leaders have agreed on launching the *Banking Union Project*, with the aim of strengthening the financial and banking system in Europe, breaking the sovereign-bank loop to reduce any systemic risk and lastly, placing European systemic banks supervision under a centralised

supervisory mechanism through the Single Supervisory Mechanism and the Single Resolution Mechanism. Even though the Banking Union marked a successful step, it still remains incomplete. Hence, sooner or later, it will have to be supported by further mechanism such as an European Deposit Insurance Scheme, to ensure further stability, spreading mutual trust and reducing banks exposures to sovereign debt while creating a risk-sharing mechanism within the Eurozone and a credible safety net.

Although the ECB has been fundamental, European member states have acted launching a series of rescue packages, in 2010, with the former temporary crisis fund, the so-called European Financial Stability Facility (EFSF) and then, in 2012 with the permanent rescue fund under the European Stability Mechanism, on the basis of art. 136 TFUE (amended with the Lisbon Treaty, in 2009) for safeguarding financial stability in Europe and providing financial assistance to those countries in difficulty, such as Greece, Ireland, Portugal and Spain. Yet, acting in this way, the credibility of art. 125 TFEU, which enshrines the *no-bail-out-clause,* has been challenged while risking to raise a problem of *moral hazard.*

Furthermore, the hard conditions inflicted by the *austerity* and the initial reluctance to concede debt restructuring (when it should have been granted to countries such as Greece) contributed to aggravate the economic scenario and damage the image of both the European Union and the EMU. Indeed, the effect were so devastating that economic recovery in the country has been seriously compromised due also to delays in conceding debt relief, which should be ensured under the supervision of credible European mediator between creditor and debtor so as to avoid the excessive interventionism of the International Monetary Fund.

Even though the financial crisis had a devastating impact, aggravated by the *austerity* that caused not only a real deflation but also a further deterioration of economic growth and unemployment, Euro member states acknowledged that a monetary union implies something more than simply sharing a single currency. Rather, it also means sharing a common destiny.

As a result, an attempt to ameliorate the current fiscal framework under the Stability and Growth Pact has been made by launching reform-packages through the TwoPack, SixPack and, lastly, the Fiscal Compact.

Although it was done with good intentions, these reforms have simply added new targets, new rules and new procedures that have further complicated an already intricate, complex, overly bureaucratic and asymmetric system. Such an overregulated system not only has pushed countries to include even a *balanced budget rule* into national systems but it has also added a series of exceptions and exemptions that simply compromise both the credibility of the system and make almost impossible to apply countercyclical fiscal policies and contain macroeconomic imbalances.

Thinking that the Eurozone will culminate in the creation of a fiscal union – it being presented as the treatment to all the Eurozone's problems – is an utopia that, sooner or later, shall be abandoned.

The failure in coordinating European fiscal policies, confirmed by the general dissatisfaction and the legal and procedural obstacles, proves sufficiently that the fiscal union cannot be created. The final

outcome might be even more catastrophic risking to exacerbate not only discontent and heterogeneities but also to extend a *one-size-fits-all principle* also in the fiscal field.

Undoubtedly, European fiscal policies are not working and, probably, a revision might be more desirable for ensuring simpler and more adequate rules to the real needs of the European economies.

Surely, the Euro has achieved a surprising support among European states and citizens, despite the flaws and deficiencies in the Eurozone framework. Especially, it has become one of the strongest currencies in the global scenario, contributing to the creation of a solid economic block, that albeit internally and regionally fragmented, is credible and competitive at international level.

Even though some European leaders crave the dismantlement of the Euro and the Eurozone, it should be acknowledged, sooner or later, the irreversibility of this process. On the one hand, some states could suffer from an economic impact due to an hypothetical economic shock and *the mother of all financial crisis,* as the economist Barry Eichengreen suggests. On the other hand, legal provisions or legal references in the European Treaties, both the TFEU and TEU, are absent for leaving the common currency (being art. 50 TUE an inappropriate legal basis and applicable only for leaving the European Union). This second aspect might be related to the deep and profound meaning attached to the single currency.

Without any doubt, the Eurozone is still incomplete and imperfect despite the impressive moral and political value given to the Euro. Yet, in the seventy years of European integration, European states have always demonstrated their willingness to cooperate and collaborate, despite some political failures, while recognising the mistakes made. Changing or, at least, improving the incredible outcomes achieved by far shall be a priority of the European leaders.

To ensure a more efficient Eurozone in the future, it will be necessary to provide member-states with new instruments, such as a European stabilization mechanism, capable of responding or counterbalancing economic downturns and, thus, ensuring a stronger financial stability while fostering a tight solidarity, that in some moments failed. In the absence of a full mobility of factors, both labour and capital as the Optimum Currency Area Theory suggests, valid alternatives will have to be found for solving the profound economic and social divergence that afflicts the system. If not, the Eurozone will risk remaining a cripple and inefficient system.

Especially, we must try to reduce the very high level of indebtedness that afflicts several members states of the Eurozone that certainly prevents not only an economic recovery but also hinders the growth of some countries. Sooner or later, mechanisms to ensure debt restructuring should be provided also for allowing the exchange of *bad debt* with *safe debt* while giving the right credibility to the *no-bail-out-clause.*

A more stable Eurozone can only be achieved when a more solid and compact market will be created.

Ensuring greater supervision of financial markets while reducing the excessive overreliance on banks through other financing alternatives, by creating a stronger capital market, could make the Eurozone more competitive and stable.

Acknowledgments

Foremost, I would like to express my sincere gratitude to my supervisor, professor Giovanni Favero for his encouragement, his patient guidance, his continuous support and for the care with which he revised accurately my thesis. It was an enormous pleasure to work under his supervision. Besides transmitting me his passion during his lectures of International Economic History, his motivation, enthusiasm, constructive suggestions and immense knowledge helped me in all the time of research and writing of this thesis. I could not have imagined having a better advisor and mentor for my Master Thesis.

Besides my supervisor, I also owe a debt of gratitude to my family for encouraging me in all of my pursuits. Without their unfailing support and continuous encouragement throughout my years of study and my whole life, this accomplishment would not have been possible. A special thanks to my mother, Kornelia, for supporting and strongly believing me in every single moment, even when I did not; my father, Walter, for letting me fulfilling my dream of being a student in the most beautiful city in the world, Venice; and to my brother, Gabriel, for being the best gift my parents could ever give me, a great life advisor, a careful brother and a good friend. All that I am I owe to you.

I would also like to extend my thanks to my American host and second family, the Ramirez Family, who continues to be part of my life supporting me and encouraging me despite the distance and miles that separate us. There are not enough words I can say to describe just how important you are and to thank you for what you do for me. I am extremely blessed you are part of my life. I love you all Vince, Linda and Bella.

Lastly, I must express my very profound gratitude to my friends, both Italians and those met during my Erasmus experiences in Germany and in Belgium and now scattered around the world. There is no way to express how much you mean to me.
A special thank is owed to my old friend, Luca Dal Canto, who stands by my side since we were children and nonetheless, he is still and always ready to cheer me up. I also thank with enormous love my dear university-mates, flatmates, life-mates and adventure-mates. Special thanks to Serena Baro, Anna Ferrara, Federica Basso, Veronica Conti, Sara Ghiraldi, Lidia Bertaglia, Sofia Moretti and Massimo Moretti for sharing with me this incredible journey in this wonderful city, Venice. It would have not been the same without you.

Isabel Cavalli

TABLE OF CONTENTS

ITALIAN ABSTRACT i

ENGLISH ABSTRACT vii

ACKNOWLEDGMENTS xiii

LIST OF TABLES AND FIGURES xvi

INTRODUCTION 1

CHAPTER I - DEVELOPMENTS OF THE EUROPEAN ECONOMIC INTEGRATION: FROM THE SCHUMAN DECLARATION TO THE EUROAREA

Part One - European integration: From nation-states to member states 6

1.1. From the Schuman Declaration to the Treaty of Paris: The European Coal and Steel Community (ECSC) 6

1.1.1..The political integration continues: The European Economic Community (EEC) 9

1.1.2. Britain on the attack: The European Free Trade Area (EFTA) 11

1.1.3. The Single Market and the Single European Act (SEA) 14

1.1.4. The tough transition: Reuniting Eastern and Western Europe 16

Part Two - The origins of the European monetary integration 18

1.2. From Bretton Woods to The Hague Summit 18

1.2.1. The Hague Summit 20

1.2.2. The Franco-German clashes and controversies: Monetarists vs. Economists 22

1.2.3. The Werner Report 23

1.2.4. Europe trapped in a ‘’snaky’’ tunnel: The European Monetary System (EMS) 25

1.2.5. The phases of the Exchange Rate System (ERM) 27

1.2.6. The role of Germany. 29

Part Three - The new era towards the European monetary union 30

1.3. Planning the EMU: the Delors Report 30

1.3.1. Building the Economic and monetary union: The Maastricht Treaty 35

1.3.2. The Convergence Criteria (or the Divergence Criteria?) 38

1.3.3. Big steps, big changes, great consequences 47

CHAPTER II - THE EUROZONE EXPERIENCE: AN ANALYSIS OF WEAKNESSES AND FRAGILITIES

Part One - Economic monetary union: A source of drifting of drifting asymmetric divergence 51

2.1. Eurozone: The creation of an imperfect system 51

2.1.1. The Optimum Currency Area (OCA) Theory and the incompatibility with the Eurozone 54

2.1.2. Asymmetric shocks and divergences in the Eurozone 61

2.1.3. Expectations vs. Reality: The European dismal performance 65
Part Two - Boom and bust: Asymmetric propagation of financial crisis 75
2.2. From the USA to the Eurozone: Stuck in the crisis 75
2.2.1. From profligacy to austerity: How Greece plunged in the crisis 80
2.2.2. From ‘’booming bubbles’’ to financial collapse: Comparing Ireland and Spain 89
Part Three – Design failures in the Eurozone 98
2.3. Creating a fragile Eurozone: A hybrid monetary system 98
2.3.1. European Central Bank (ECB): An excessive attention to price stability and inflation? 98
2.3.2. The big shift: ECB as a crisis manager and lender of last resort 104
2.3.3. ECB vs. unconventional monetary policies: The right approach? 109
2.3.4. Economic policies in the Eurozone: A climax of fragilities 114

CHAPTER III - REBOOTING EUROZONE: CREATING A MONETARY UNION THAT (MIGHT) WORK

Part One - The great dilemma in Eurozone: Break it up or love it? 120
3.1. The unifying role of the Euro? 120
3.1.1. Breaking-up Eurozone: «A long, costly and messy divorce» 124
3.1.2 Minimal conditions for avoiding an Eurozone break-up. 130
Part Two - Strengthening Eurozone framework: Preserving financial stability 134
3.2. Completing the Banking Union: Creating a European Deposit Insurance Scheme (EDIS) 134
3.2.1. Launching a European Monetary Fund (EMF) 141
3.2.2. Making the best of the Single Market: Creating an ambitious Capital Market Union (CMU) 149
3.2.3. Reforming the European Central Bank: The right time for a dual-mandate, accountable and transparent bank? 153
Part Three - Refocusing Eurozone fiscal framework: Overcoming the complex nature 168
3.3. The Dilemma of Eurozone Fiscal Union: The impossible solution 168
3.3.1. Reforming the Eurozone Fiscal Framework: Changing the targets, improving the system 172
3.3.2. Resocialising Eurozone: The European Unemployment Insurance Scheme (EUIS) 180
3.3.2.1. Creating the right legal framework for EUIS 189
3.3.3. Designing a debt restructuring framework and a credible no-bail-out clause 197
3.3.3.1. GDP-linked bonds: A solution to crisis? 203

CONCLUSIONS 212

BIBLIOGRAPHY 219

WEBSITES 228

LIST OF TABLES AND FIGURES

Table 1.1. The European countries and the Convergence Criteria 46

Figure 1.1. GDP Volume Growth in the Eurozone 1999-2018 73
Figure 2.1. Unemployment rate in the Eurozone (as a % of labour force) 1998-2018 73
Figure 3.1. Youth Unemployment rate in the Eurozone 1999-2018 74
Figure 4.1. Government debt (consolidated) (as % of GDP) in the Eurozone 1999-2018 74
Figure 5.1. Greece Credit Expansion and Capital Flows 2001-2018 87
Figure 6.1. Greece Government debt to GDP 2001-2018 87
Figure 7.1. Greek Unemployment Rate 2001-2018 88
Figure 8.1. A comparison between Spanish and Irish House and Residential Prices 1999-2018 96
Figure 9.1. A comparison between Spanish and Irish Government Debt to GDP 1999-2018 96
Figure 10.1. A comparison between Spanish and Irish Unemployment Rate 1999-2018 97
Figure 11.1 A comparison between Spanish and Irish GDP Annual Growth Rate 1999-2018 97
Figure 12.1. ECB Inflation Rate 1999-2018 103
Figure 13.1. ECB interest rate 1999-2010 103
Figure 14.1. ECB interest rate 2008-2018: the Zero Lower Bound 113
Figure 15.1. EU Central Bank Balance Sheet 1999-2019 113

INTRODUCTION

The history of European integration is surely the most incredible form of cooperation ever seen among European countries and the most remarkable achievement of the twentieth century, after decades of atrocious wars. European countries designed, indeed, a system based on solidarity, unity and cohesion while overcoming intense hostilities among states, especially between France and Germany. This intense cooperation has not only changed European political, economic and social context but has also brought the longest period of peace ever recorded in the European history.

With the launch of the European Coal and Steel Community through the ratification of the Treaty of Paris (1951) among Six founding member-countries - inspired by the former French Foreign Minister, Robert Schuman and the French Politician, Jean Monnet - high expectations of succeeding towards further economic integration were placed.

Driven by a spirit of collaboration, European countries culminated in a series of significant treaties, shifting from the Treaty of Rome (1957), which gave birth to the former European Economic Community (EEC), to the Single European Act (SEA) in 1985. However, of all developments from the outset of political-economic integration, the launch of the European Monetary Union (EMU) with the introduction of a single currency in 1999, through the ratification of the Maastricht Treaty (1992), stands as the most ambitious and debatable step of *Europeanization*, centralisation of European policies and deeper integration.

The Euro has been the result of a complex economic-political construction and ideological clashes over monetary-economic integration between *economist view* and *monetarist view*, on the assumption that prosperity and growth would have been fostered while the Single European Market fully exploited.

To ensure a fair process for joining the Euro starting from the 1st January 1999, European countries had to demonstrate their commitment to macroeconomic discipline by meeting Convergence Criteria that would have determined whether countries were prepared to proceed towards an *irreversible step* by adopting a single currency and a common monetary policy.

By underestimating the impact of a rigid Euro while ignoring the real structural economic conditions under the Optimum Currency Area (OCA) Theory, politics simply won over economic merits and convergence criteria were simply bypassed.

Eleven European countries joined an imperfect and incomplete Eurozone system, built with minimal conditions and insufficient tools. On the one hand, the mandate of the European Central Bank (ECB) focuses on price stability as its *primary objective* with an asymmetric inflation-target defined by «*close but below 2%*» driven by the «*one-size-fits-all principle*». On the other hand, pro-cyclical and complex fiscal policies are now constrained by numerical imposition settled by the Stability and Growth Pact (SGP): a 3% deficit-threshold and 60% debt-to-GDP ratio.

Inevitably, consequences through economic asymmetric shocks, internal fragmentation, different business cycles and macroeconomic imbalances, and increasing divergence emerged resulting in two

main distinctive groups: the «Core countries» and the «Periphery countries».

Since the launching of the Euro, the currency has exacerbated differences among Euro-members, in terms of competitiveness, unemployment and different impact of recession to the extent that the current dismal performance is affected by «*a secular stagnation*». Yet, the magnitude of cross-border capital flows has increased substantially with destabilizing effects that became evident starting from 2009, when current account deficits, banking and financial pressure almost brought Euro to financial collapse.

Acting Greece as propagator, all Euro-countries were contaminated and experienced a severe full-blown crisis evolving from a liquidity and banking one to a sovereign debt one.

«The Great Recession» not only marked the beginning of a more divergent, heterogeneous and unsustainable economic situation but it also revealed substantial flaws and fragilities in the Euro-system: an initial reluctant ECB prompt to act as a lender of last resort, a banking supervision limited at national level, the absence of both risk-sharing mechanism and automatic stabilizers and inappropriate fiscal rules and lastly, an excessive quantity of government debt held by banks in a currency area deprived of Lender of Last Resort (LOLR) and automatic stabilizers.

Bypassing art. 125 TFEU (*no-bail-out clause*), rescue-bailout-packages were activated either through the former temporary European Financial Stability Facility (EFSF) and the following permanent rescue fund under the European Stability Mechanism. Yet, this financial assistance came at cost of strict and debatable conditions under «austerity», whose levels were so high to compromise economic recovery and where excessive involvement of ECB in the Troika was highly criticized.

Still, under the presidency of Mario Draghi with his «*whatever-it-takes*» announcement, some significant changes occurred that contributed to a general amelioration of the financial distress and re-establishment of a stabilizing force.

On the one hand, the ECB proved to be an evolving institution and abandoned the traditional and excessively conservative monetary approach, even though with some delays. Not only did the Central Bank finally act as a LOLR but it also, activated a series of unconventional monetary policies through the Quantitative Easing Program, Securities Market Program (SMP) and Outright Monetary Transactions (OMT) for saving both the Euro and the Eurozone. Similarly, to ensure an increasing financial stability in the Eurozone, it finally launched the Banking Union project enhancing a centralisation of banking supervision.

On the other hand, European member states have attempted to ameliorate the current Eurozone pro-cyclical fiscal framework - it being established on a weak Stability and Growth Pact. Yet, the targets introduced (through Two Pack, Six Pack and Fiscal Compact) have resulted in a very overregulated, asymmetric and complex set of rules, procedures and surveillance mechanisms. Not only has a European budget rule been transposed in national systems, but also many exemptions and exceptions have been introduced. Hence, credibility has been weakened while the pro-cyclical fiscal effect fostered.

To worsen the situation, the Eurozone is an incomplete and crippled system where appropriate risk-sharing arrangements and deposit insurance schemes are absent. Moreover, fiscal policies are inadequate to reduce, through counter-cyclical policies, enormous macroeconomic imbalances and significant divergences at Euro level while focusing on national-domestic real needs. Hence, the Eurozone is still exposed to enormous fragilities and vulnerabilities.

The Euroarea was not established on economic merits but as a next step for completing the European integration project while exploiting all potential benefits of the single market, barely supported by an appropriate political and institutional integration.

Creating a monetary union does not only imply sharing a single common currency. It is also about sharing institutions for adopting policies to counterbalance instabilities and asymmetries. Probably, the project of integrating too many different European economies in one monetary union, with one single currency, might have been excessively ambitious.

Finding solutions for rebooting the Eurozone stability through innovative solutions shall be a priority for the member states in their own interest. Europe will otherwise risk being stuck in a fragile construction with low growth, high unemployment and incomplete system.

With this research, I aim at understanding the process of European economic integration, both the goals and reasons that led member states to give up part of their sovereignty in favour of a centralised one while keeping a decentralised fiscal system.

From these premises, by analysing what went wrong in the process of economic and monetary integration, I am trying to conduct an analysis on the inefficiencies, weaknesses and fragilities affecting Eurozone system by considering also fiscal and monetary framework surrounding Euro member states. Using such an analysis as a ‘’stepping-stone’’, I am also aiming at raising hypothesis and considerations over a hypothetical amelioration of the Eurozone framework that might hopefully contribute to reboot the Eurozone economy and ensure an increasing financial stability.

Evidently, in order to answer such questions, multiple factors and aspects shall be taken into account. To this end, by providing a critical analysis, I will structure the thesis into three macro-chapters by following a logic and linear key to interpretation.

Chapter I provides an historical background of European economic integration while focusing on the evolution of different steps in the process. Starting from the very origins with the ratification of the Treaty of Paris (1951) and the launching of the European Coal and Steel Communities, passing through the Treaty of Rome (1957) and the creation of the European Economic Community (EEC) and lastly of the Single European Act (1986), I will try to rebuild the long path towards the effective creation of the monetary union, which saw its birth only through the ratification of the Maastricht Treaty (1992). However, since the idea of creating a monetary union was present since 1969, a special and particular attention to both the *Werner Report* (1969) and also the *Delors Report* (1989) but above all, to the European monetary and historical post-Bretton Woods background, will be given.

Understanding European economic integration requires surely a good notion of its development. As a

matter of fact, I will analyse also the European Monetary System (1979) by considering not only its functioning but also the prominent role of Germany within the system as it would have influenced the mandate of what it is today the European Central Bank. Similarly, the criteria chosen known as the Maastricht Criteria will be studied accurately for two main reasons: (1) they provide an inappropriate analysis for creating an optimum currency area and (2) they were violated.

Chapter II focuses on the analysis of inefficiencies and weaknesses of the Eurozone system. By examining the Optimum Currency Area (OCA) Theory, I am trying to put into evidence the main structural elements that are necessary and fundamental for proceeding towards the creation of a currency union and the resulting incompatibility with theEurozone real structure.

The disrespect and avoidance of the appropriate analysis might be the source of asymmetric shocks, divergences in the Euro economic performance. Therefore, this argument will be supported with graphs and figures.

Moreover, a special attention will be given to the severe full-blow financial crisis, the Eurozone sovereign debt crisis. By analysing its origin, three case studies - Greece, Spain and Ireland – will be considered for the impact of financial assistance and also for significant events that have occurred.

Hence, the evolution of the European Central Bank and its functioning before and after the financial crisis will be studied. Hence, I will put into light its excessive obsession for inflation and price stability (source of mistakex in monetary policy), its action as a crisis-manager and lender of last resort and lastly, the launching of unconventional monetary policies. Similarly, the Eurozone fiscal system - one of the primary sources of instabilities and imbalances - and the provisions adopted by the European Commission and Eurozone member states for sheltering and saving Eurozone system will be evaluated.

Chapter III analyses measures and improvements that might be required for enhancing a solid financial stability of the Eurozone, since the Euro stands as *an irreversible step* and the dismantlement of the Euro might emerge as a very costly and lengthy process due to an absent *ad hoc* legal framework.

This chapter stems from a personal experience in the heart of the European Union, Bruxelles that proved to be crucial. Having the chance of monitoring EU legislative proposals in banking and financial fields, during an internship in European banking cooperation, I entered into contact with mechanisms and measures that are currently debated among European institutions - the European Commission, European Parliament and Council. From this experience, I developed my views and considerations on the possible institutional mechanisms that could foster a better and smooth functioning of the Euro-system.

Despite the launching of the European Banking Union - with the Single Supervisory Mechanism and the Single Resolution Fund - and the creation of a European rescue fund (under the European Stability Mechanism) for solving liquid and solvent crisis, further major institutional *ad hoc* mechanisms need to be proposed.

As a matter of fact, I will try to demonstrate that the fiscal union might not be the right approach for

Eurozone countries due to legal obstacles that would hinder its creation. Rather, a revision of the current fiscal and monetary framework would be more appropriate.

Furthermore, I will raise hypotheses and considerations for strengthening the Eurozone framework by creating a European Deposit Insurance Scheme and transforming the European Stability Mechanism (ESM) into a European Monetary Fund (EMF), which should be entitled to operate also with the defaulting and insolvent countries.

Being inspired by the 2016 G20 Hangzhou Summit, I will raise an hypothesis over a debt restructuring framework supported in conjunction with the issuing of a financial innovation through GDP-indexed bonds (GIBs), whose functioning will be deeply and accurately explained.

Nonetheless, being the Eurozone system dominated by a bank system, I am also considering financing alternatives by creating an ambitious Capital Market Union (CMU), intended to offer less volatility and more portfolio diversification.

Lastly, in the absence of an automatic stabilization mechanism, I will hypothesize the creation of a system and scheme for resocialising the Eurozone under the European Unemployment Insurance Scheme (EUIS), whose legal framework will be analysed so as not to incur into violation of art. 125 TFEU or any other legal text.

CHAPTER I

DEVELOPMENTS OF THE EUROPEAN INTEGRATION: FROM THE SCHUMAN DECLARATION TO THE EUROAREA

PART ONE

European integration: From nation-states to member states

1.1. From the Schuman Declaration to the Treaty of Paris: The European Coal and Steel Community (ECSC)

The idea of Europe has been present for centuries but the establishment of the European Union, as it is today, has required a long period made of complicated and tough negotiations. The understanding of the European integration needs the comprehension of the mindset as well as the historical contest that characterized the years after the Second World War – a period in which the devastation and the economic and political situation in Europe was extremely dreadful and terrible[1]. Politicians started to ask themselves how to avoid another war in the future and this led to think about the possibility of promoting cooperation and an eventual integration among all the European nations[2]. Europeans were worried about economic and domestic reconstruction and the United States were making pressure on the need of promoting free markets, non-discrimination and free trade as it was also promoted at the Bretton Wood conferences, in 1944. Soon after the war, states started applying policies broadly inspired to Keynesianism. Such policies – which included a strong intervention of the state, high expenditures in social welfare, and economic planning – became the basis for the reconstruction of the European economy.

With regards to Europe, steel and coal were given a major role in the post-war economic reconstruction and the starting point for the European integration and cooperation among the states. By the time, after WWII, the French Foreign Minister, Robert Schuman, and Jean Monnet, both led by a strong pro-Europe enthusiasm, were convinced that the starting point for cooperation had to be found

[1] J. McCormick, *Understanding the European Union*, Hampshire, MacMillan Distribution, 1999, pp. 57-59.

[2] R. Baldwin, *The economics of European integration*, Berkshire, McGraw-Hill Higher Education, 2009, pp. 4-9.

in the resolution of the tensions and rivalries between Germany and France by adopting a different approach. Following this idea, they were both sure of the fact that Germany had to be given the chance to re-establish an industrial sector so as to gain a more prominent role on the international scenario and in the European reconstruction. Jean Monnet identified in the coal and steel industries the common ground for establishing a possible cooperation following the considerations that being both coal and steel crucial blocks of industry, a potential cooperation would have enhanced development, contained German power and, lastly, removed French fears of a possible strong German domination and competition in the sector. Indeed, Germany would have been involved in trade with all the rest of the European countries[3].

As a matter of fact, on the 9th May 1950, Robert Schuman moved forward with the plan culminating in the '*Schuman Declaration*', making a surprising announcement over coal and steel production[4]. The Schuman Plan demanded the extinction and the suspension of the rivalries and hostilities between Germany and France. Besides this, Schuman was also aware of the fact that the coal and steel sectors of both countries had to be controlled by a supranational authority - the High Authority - for two reasons: first, these two sectors stood as the pillars for guaranteeing stability of an economic, military and industrial strength and secondly, it was seen as the precondition for introducing an organization for involving also other European countries in this project. The introduction of a High Authority, that would have been placed over French and German production, was intended to provide an equal supply of coal and steel in a common market. Surely, the establishment of such partnership stood as a revolutionary move represented by a loss of sovereignty in the name of a new era characterized by cooperation, peace and collaboration.

Jean Monnet conducted the French negotiations with West Germany and other four member countries, Italy, Belgium, Luxembourg and the Netherlands, which became known as 'The Six' and joined this ambitious plan. This was driven by the desire of achieving greater economic prominence and stability and by the wish of reducing vulnerabilities against a powerful country such as Germany[5]. By proceeding in this way, European reconstruction and the Franco-German alliance would have started and doomed to last for more than sixty years.

---

[3] J. McCormick, *Understanding the European Union*, cit., pp. 65-66.

[4] On the 9th May 1950, Robert Schuman held, in Paris, a brilliant and stunning speech, which became known as the ''Schuman Declaration'' and is now considered to be the starting point of the European Integration. He thus affirmed: «Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a *de facto* solidarity. The coming together of the nations of Europe requires the elimination of the age-old opposition of France and Germany. Any action taken must in the first place concern these two countries. […].The pooling of coal and steel production should immediately provide for the setting up of common foundations for economic development as a first step in the federation of Europe, and will change the destinies of those regions which have long been devoted to the manufacture of munitions of war, of which they have been the most constant victims». Fondation Robert Schuman, ''Declaration of 9th May 1950 delivered by Robert Schuman'', *European Issue*, 10th May 2011, p.1, https://www.robert-schuman.eu/en/doc/questions-d-europe/qe-204-en.pdf, consulted on the 22th September 2018.

[5] R. Baldwin, *The economics of European integration*, cit., pp. 11-12.

The ''Schuman Plan'' established the framework for negotiations among the states which led to the Treaty of Paris, on the 8th May 1951 and the creation of the European Coal and Steel Community (ECSC). The Treaty of Paris should be emphasized for being a very complex commercial treaty under the control of a supranational entity, introduced with the scope of balancing the equilibrium among six member countries and facilitating the achievement of national objectives[6]. The ECSC contributed to the creation of a common market among six different countries, whose primary aim was to encourage the removal of any obstacle to economic partnership and cooperation by reducing tariff barriers, abolishing subsidies and fixed prices.

This Treaty was perceived as a great achievement since it demonstrated that European integration was highly possible and that European countries could collaborate with one another in the direction of further economic integration, remarked by the memorable decision of giving up significant sovereign power in favour of a supranational institution[7]. This body, indeed, had been introduced as an ingenious solution driven by Jean Monnet on the basis that it could have contributed to the resolution of tensions between France and Germany.

The reasons why Germany and France intended to advance cooperation were different, both political and economic. On the one hand, Germany recognised that the only and possible way for promoting the national recovery was by accepting the Schuman Plan; on the other, France was more focused on the political gains, on the assumption that German industrial domination would have been contained[8]. On the contrary, the United Kingdom rejected the idea of joining the ECSC showing from the very beginning its ambiguous and contrasting relations. On the one hand, they did not want to open negotiations upon the pooling of coal and steel production; on the other, they were not interested in accepting the transfer of sovereignty to a High Authority[9]. Despite their rejection, the ECSC was signed giving birth to an initial form of cooperation that would have lasted.

---

[6] M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration*, London, Routledge, 1996, p. 61. The fact that coal and steel have been the first sectors to be incorporated in a treaty and in a super-national organization demonstrates their importance for a country's economy and military power. Coal and steel had provided military capability for both France and Germany to invade the respective countries for having direct access to Alsace Lorraine, endowed with iron deposits, and the Saar, enriched with coal. R. Baldwin, *The economics of European integration*, cit., p. 7.

[7] J. McCormick, *Understanding the European Union*, cit., p. 67.

[8] Coal and Steel were the building blocks of both France and Germany's industry. Their cooperation in this field would have gradually eliminated excessive wastes by breaking down cartels that were usually created. Hence, industrial development and production would have been boosted making it more efficient. Moreover, from the French point of view, German power, which established its industrial dominion upon the Ruhr, would have been contained through the creation of a supranational coal and steel industry. Hence, disputes over Alsace-Lorraine – a region whose coal reserves had been contended by both France and Germany – would have been limited, if not disappeared. Finally, European leaders were convinced of the fact that Germany would have relied more on trade with other European countries for further supporting its economic reconstruction while French fears of an invasion or German dominion could disappear. *Ivi*, p. 66.

[9] The reasons why the United Kingdom was not interested are different. First of all, it could rely on a strong economic relationship with the Commonwealth for the access to raw materials. Secondly, the real opposition came directly from the British coal and steel industries, being extremely hostile to the other European

In the mind of Schuman, however, it was not only the first step toward an economic integration but the birth of a federated Europe.

After the ratification, the ECSC launched an efficient and effective Common Market, which worked extremely well until 1957, when a first crisis emerged in the ECSC. Indeed, despite the initial enthusiasm, the ECSC failed to reach some goals and some projects arranged that were perceived as a ''wet blanket'' for those who were hoping in a rapid and solid integration[10]. Nonetheless, this supranational institution had a significant political impact emphasized by well-working institutions, capable of operating and setting rules[11]. Europeans, that had spent decades at declaring war to each other, demonstrated their willingness to cooperate and collaborate.

1.1.1. The political integration continues: The European Economic Community (EEC)

Given the enormous success of the ECSC, despite some blunders, already starting from 1952, considerations for a possible expansion of a common market started being raised by the Dutch Foreign Minister, Jacques Beyen, in spite of an initial defensive approach from both France and Germany. Nonetheless, in June 1955, the Foreign Ministers of The Six met in Messina under the auspices of developing common institutions, creating a common market and gradually harmonizing their policies by relaunching the idea of European integration. A committee, chaired by the Belgian Minister Paul-Henry Spaak, was set up and issued an important report, «the Spaak Report», which conveyed both advantages and benefits of creating a common market[12].

The report further stimulated the round of negotiations, at a quick and impressive speed never seen before, converging into the second most important Treaty: the Treaty of Rome. This was signed by

---

countries. Third, it was in no way dependent on Germany for the access to the Ruhr or Saar and lastly, it was no really threatened by Germany in terms of security. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration,* cit., pp. 64-67.

[10] Soon after the Paris Treaty (1951), the Six member states tried to extend their cooperation to the area of defense by considering a proposal that came directly from the French Prime Minister, René Pléven. The so-called ''Pléven Plan'' aimed at creating a common defense and a European army for ensuring security of the member states, which even led to a second Treaty, in Paris, that established the European Defense Community (EDC). However, due to strong disagreement among the member states, the EDC turned into a failure demonstrating that a solid political integration was still a far goal. Similarly, the European Political Community, following a draft proposal in 1953, was supposed to move European integration toward a federation but in the wake of the failure of the EDC, also the EPC reached an impasse. J. McCornick, *Understanding the European Union,* cit., p. 68.

[11] The ECSC was working under the supervision of a High Authority, which had full control over the coal and steel sectors. This body was thus composed of nine members, committed to a mandate of six years and selected by the national governments and assisted by a committee of workers, consumers and producers. At the request of The Netherlands and Belgium, High Authority's powers were reduced allowing it to issue only non-binding decisions and opinions. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration,* cit., pp. 67-68.

[12] A small working-group was set up under the Chairmanship of Paul-Henri Spaak, involving experts from the ECSC, such as the French economist Pierre Uri, with the aim of setting a guideline or at least, a plan for proceeding toward a common market. The Spaak Report, which was mainly thought and written down by Pierre Uri, was submitted and approved in the Venice Conference, in May 1956.

the Six countries on the 25th March 1957, creating the European Atomic Energy Community (EURATOM), a common market for nuclear materials, and the European Economic Community (EEC), a common market for the agricultural and manufacturing sectors with the introduction of a Common Agricultural Policy (CAP), highly wished by the French government and based on free exchange of agricultural foods with a minimum level of prices[13].

The EEC was a pure commercial treaty between six member states regulated, once again, by a supranational community and with the intention of enhancing economic and political benefits and expanding trade and growth in Europe. However, it was evident that despite being a Dutch proposal, the Treaty of Rome reflected some major French concerns stressing the fact that economic integration could proceed mainly when national interests were mainly connected to Germany or related to the Franco-German axis[14]. An ever closer relation between France and West Germany would have consolidated the birth of a new Europe.

The Rome Treaty, though a pure statement of intentions and action programme, became the foundation and the basis for all subsequent European projects and a closer union among European countries and nations, following the failure of the EDC[15]. The Treaty of Rome had provided a significant and ambitious plan for promoting economic and commercial expansion and improving common welfare and social policy in Europe. As a consequence, the Six countries were committed to being engaged in a deeper economic integration thanks to the creation of a common market, which was characterized by the removal of tariffs and quotas, the adoption of a common external tariff - based on a simple arithmetic average among the Six's pre-EEC tariffs - labour mobility and freedom of movement of persons and services and, finally, common policies for attaining a not-distorted

---

[13] Considering the administrative structure of the new-born EEC, three new institutions were created: the European Commission, the Council of Ministers and the Parliament. The Commission played a crucial role having a multifunctional purpose by acting as an executive civil service and being committed to representing Community interests. In addition to this, the Commission was entitled with ensuring that member states respected effectively their obligations and the rules contained in the Treaty, so as to avoid non-compliance or inappropriate behaviours. Together with the Council of Ministers, they emerged as supranational authorities, even though the former took decisions on the Common Market and atomic energy and was even entitled with issuing binding decisions that had to be respected. Finally, by the time, the European Parliament was not a legislature to the extent that its decisions and opinions could be simply dismissed and not taken into consideration by the Council of Ministers. Nonetheless, starting from 1972, they were entitled with the *co-decision power* with the Council of Ministers for important issues, i.e. internal market law, development and training, diminishing democratic deficit. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration*, cit., pp. 95-97.

[14] The Treaty of Rome is the proof that European integration was basically rotating around the Franco-German axis. On the one hand, France was driven by economic motivations and saw in the common market a way for further expanding not only its agriculture and economy but above all, for enhancing European trade and prosperity. Lastly, France identified in the common market the way for guaranteeing a French influence and leadership in Western Europe. On the contrary, Germany was purely driven by political considerations having recognized that the establishment of a common market could have been the starting point for a pacific reconciliation between Germany and the other European neighbours where France could be the main promoter and supporter. *Ivi*, cit. p. 103.

[15] R. Schütze, *The European Union law*, Cambridge, Cambridge University Press, 2015, pp. 12-13.

competition to be reached in three or four stages starting from 1958[16]. Indeed, the main aim for creating a Common Market was to create one powerful economy with a significant voice on the global scenario[17].

In January 1958, the six member countries had already reached significant steps by signing the treaties and introducing important and ambitious goals for enhancing market integration.

Import quotas were removed by 1961 while a common external tariff was introduced in July 1968. All the measures adopted contributed to expanding trade, which stunningly exploded between 1958 and 1965[18]. The establishment of the Common Market was possible also thanks to the unprecedented prosperity, dominated by low unemployment and sustained growth, which characterized the ''golden age'' between 1950-1970s. The Six opened a period based on collaboration and strong economic integration, marked by an enormous increase in GDP, industrial growth and commercial success[19].

1.1.2. Britain on the attack: The European Free Trade Area (EFTA)

Even though the European integration had gradually and successfully proceeded, the United Kingdom had kept a very ambiguous and dissenting position towards the ambitious plan proposed by Jean Monnet and Robert Schuman. Being afraid of jeopardising its special and preferential relationship with the Commonwealth and establishing a too close relation with the other European countries, once again Britain rejected the idea of joining the EEC on a series of political considerations that resulted in mere misjudgements[20]. Once the Spaak Report was approved and the Six were ready to proceed towards the Treaty of Rome, Britain, pressured by other states, such as Switzerland, Sweden and

---

[16] See Art.3 of the Treaty establishing the European Economic Community, [1957].

[17] One of the main architects of the Common Market, Pierre Uri, was convinced of the fact that the common market could have been the starting point for emerging into a solid fiscal and monetary union on the assumption that by fusing six economies into one single bloc, with common rules and policies, national responsibility and sovereignty would have given birth to one supranational body of the EEC. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration,* cit., pp. 97-98.

[18] The Treaty of Rome set a deadline of twelve years for removing all the barriers and establishing the Common Market. Quite quickly, all the tariffs were removed and by 1968, all the member states agreed on the common external tariff. By removing also quota restrictions that member states used to apply on the imported products as a form of protectionism, both trade integration and intra-EEC trade grew. On the one hand, consumption in The Six grew at 4.5% per year; on the other, member states enjoyed an annual growth at 5.7%. J. McCornick, *Understanding the European Union,* cit., pp. 69-70.

[19] It is very hard to say whether the effective economic expansion is only and exclusively related to the Common Market, though it had been proved that productivity increased substantially by 19%, overcoming the US and UK production. In any case, it should also be acknowledged the fact that the industrial economy jumped over 90% between the 1950-1960s. This might confirm the fact the Common Market was not failing in its intent. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration,* cit., pp. 111-112.

[20] The unfriendly attitude of the United Kingdom towards the process of European integration can be traced back to the Second World War – years in which the British wartime experience contributed to developing a strong national identity and reinforced the strength of its political institutions and sovereignty. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration,* cit., pp. 106-108.

Portugal, opted for a counter-initiative with the aim of contrasting the Common Market and counterbalancing a possible discrimination[21].

The European Free Trade Area (EFTA) was established in Stockholm, on the 20th November 1959, entering into force in May 1960. An intergovernmental body, composed of Britain, Norway, Sweden, Denmark, Austria, Portugal and Switzerland, was settled down with the aim of creating a free trade area rather than opting for an economic and political integration. The EFTA was later extended to Finland in 1961 as an associate member and then, Iceland in 1970[22].

The EFTA allowed to reduce gradually tariffs and promote trade liberalization at the same speed of the EEC, though it did not have the same influence. On the one hand, those who were benefitting were small countries, like Sweden and Switzerland; on the other, the only big market was the British one.

The EFTA that was initially born for contrasting the EEC and showing that a free trade area could actually work, drifted into a failure to the extent that the United Kingdom decided to give up and apply for EEC membership in 1961, being afraid of becoming isolated, discriminated in a faster-growing market and cut off from any commercial relations, which was perceived as a national failure[23]. This new attitude gave birth to a '*'domino effect''* opening the lead for further enlargements: Denmark and Ireland were pleased about Britain's application, in contrast to Sweden and Switzerland[24].

Even though membership could be expanded to any country willing to join, in this case, it was not given automatically. With regards to UK, the negotiations underwent a very complicated path as her membership was perceived negatively and was not really appreciated due to the lack of enthusiasm and due to strong criticism raised towards the European integration. Moreover, at the very basis of the European cooperation, the forgotten tensions between France and Germany were the key for promoting progress and a successful feature to the extent that France had no intention of sharing the leadership with Britain. Because of this solid opposition, the British application was initially vetoed by De Gaulle's France, in 1963 and 1967. Likewise, being Denmark and Ireland part of a joint package, they both saw their membership blocked[25].

---

[21] *Ivi*, pp. 109-110.

[22] R. Baldwin, *The economics of European integration,* cit., p.17.

[23] The reasons why United Kingdom abandoned its initial antagonist approach are different and multiple. Firstly, UK had gradually lost its role of global leader and world power. Secondly, the US started privileging foreign relations with the EEC rather than with Britain on the assumption that the former was more trustworthy and reliable while the latter lost credibility. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration,* cit., pp. 113-114.

[24] In 1961, Denmark applied on agricultural considerations having recognized the importance of the EEC market. By joining, they could have expanded their industrial sector and increased their agricultural production. Similarly, Ireland did not simply join with the scope of expanding the industrial sector but also with aim of diminishing its dependence on Britain. In 1962, Norway applied on the consideration that the EEC market was very influential and important. Finally, the other countries, namely, Sweden, Austria, Switzerland, Portugal, Spain and Malta followed having recognized the fact the EFTA had lost its *raison d'être.*

[25] J. McCornick, *Understanding the European Union,* cit., pp. 71-72.

In the end, Britain, Denmark and Ireland reapplied for the third time in 1969 which even corresponded with De Gaulle's resignation and appointment of Georges Pompidou at the French presidency[26]. With this political turn and a different approach to Britain, a Summit was held in The Hague, in 1969, with the aim of further enlarging, deepening and completing the EEC by 31st December 1969. In this context, Britain, Ireland and Denmark, and Norway had been granted membership for the EEC, which effectively occurred for the first three countries in 1973[27]. The European Communities thus shifted from being composed of Six members to Nine[28]. Still, this conference is remarkable and should be kept in mind for another important fact: the institution of the Werner Committee, which would have issued an important report on the Monetary Union.

The enlargements, however, did not stop, as in the 1980s, Spain, Portugal and Greece, having adopted and introduced democratic regimes, became eligible for EEC membership[29]. Therefore, following these developments, Greece joined in 1981 while Spain and Portugal in 1986, on the assumption that EEC membership would have further encouraged and enhanced democracy[30]. Their accession expanded once again the initial project of nine members up to Twelve, entailing several political consequences. On the one hand, EEC influence became much more prominent and contributed significantly to transforming the trade bloc into one of the biggest in the world being able to compete against the US economy. On the other hand, the process even complicated and altered economic stability and balance of the EEC, especially, by accepting poorer regions such as Spain, Portugal and Greece[31]. These developments led to the conclusion that it was necessary to deepen the coordination, cooperation and relationship between the members before enlarging further.

---

[26] Britain reapplied a second time in 1967 but still, its application for membership was once again rejected by France, in contrast to Germany that had always kept a positive approach to the Britons and was in favour of the United Kingdom's membership. R. Baldwin, *The economics of European Integration,* cit., p. 19.

[27] The terms between Britain and the EEC had been established in June 1971, stressing the fact that UK had to eliminate tariffs in five steps of 20% reductions each by July 1977, with a period of transition of four years for obtaining full membership. Having the British economy dropped reaching very low standards of living and a low-competitive industry and economy, UK found herself in a very weak position, incapable of rejecting again a full membership. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration,* cit., pp. 120-121.

[28] Norway that had initially applied for membership was prevented from continuing negotiations due to a public referendum. On the 25th September 1972, a referendum was held on whether Norway should have joined the European Community or not. Surprisingly, a large majority of Norwegians (53.5%) voted against the accession.

[29] Greece had already applied for EEC membership in the late 1950s but was rejected on the assumption that the Greek economy was too underdeveloped and could undermine the stability of the European market. However, it was given *the associate membership status* as a prelude for full accession. Similarly, both Spain and Portugal had applied in the 1960s for associate membership but both were rejected as they were under dictatorship. Therefore, they were simply given a preferential trade agreement (Spain in 1970 and Portugal in 1973). It was only in 1975, with the end of the dictatorships, that their requests for memberships were taken seriously. J. McCornick, *Understanding the European Union,* cit., p. 72.

[30] R. Baldwin, *The economics of European Integration,* cit., p. 24.

[31] After years of tough negotiations (1977-1986), Spain and Portugal joined, even though for the EEC it became

1.1.3. The Single Market and The Single European Act (SEA)

The enlargements reached by the mid-1970s complicated negotiations among the countries, incapable of reaching further agreements. The period between the 1970s and the 1980s was thus marked by very few progresses, initiatives and no further integration. The ambitious project stagnated for a while soon after its establishment, remaining uneven and coming to a real deadlock, being even complicated by a quite unstable period[32]. This was characterized by political crises and economic shocks in the 1970s that depicted a phase known as '*Euro-pessimism'* or '*Euro-sclerosis',* having significant implications on the EEC government policies and economies[33]. As a matter of fact, until 1984, no significant political decision was taken for promoting a further political convergence which was strictly related to the fact that different EEC economies had divergent priorities: Germany was focused on reducing inflation while France and Italy were more concerned with lowering unemployment.

The EEC was a solid economic community where integration worked commercially. Yet, as soon as economic conditions worsened, each member state reacted by applying virtually protectionist measures, threatening the successful integrity of the Common Market[34].

The EEC countries introduced, indeed, new technical norms, regulations and standards known as technical barriers to trade (TBT) with the aim of protecting consumers but with the dramatic effect of limiting, distorting and fragmenting the European markets. These actions clearly slowed down the harmonization as well as the process of European integration to the extent that it was believed that the ideals that had driven cooperation and collaboration were dying[35].

Already starting from 1981, the situation started changing, when a positive recover begun, inflation gradually declined and unemployment started decreasing. This new framework corresponded also with the arrival at the presidency of the Commission of a strong supporter of the European integration, Jacques Delors, who was interested in rescuing the European industrial and commercial market by adopting a pro-Europe attitude. He wanted, indeed, to push further the completion of the European

---

quite hard to absorb those big and not-well-developed agricultural countries that would have direct access to the CAP. By taking this decision, the EEC was thus exposed to a considerable strain on the EEC budget. Besides this, Spain was very difficult to include in the EEC because of an economy mainly based on fishing, a very sensitive issue in the EEC. On the contrary, Greece being a small agricultural state did not show major problems being easily integrated in the EEC. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration,* cit., pp. 127-128.

[32] *Ivi*, p. 123.

[33] *Eurosclerosis* is a term coined during the 1970s for describing a period marked by economic stagnation, high unemployment and inflation that resulted in a loss of confidence in the European minds and in unfavourable framework for further promoting the European integration. On the one hand, the international economic environment complicated by the suspension of the Bretton Woods System and the consequences of the Arab-Israeli War in 1973 subverted the political and economic context in which EEC was operating giving path to protectionism among member-states and less inclination to integration. On the other, the difficulty of the EEC was marked by the expansion in membership and complexity of decision-making. A. Anesti, ''The Myth of Eurosclerosis: European Integration in the 1970s'', *L'Europe en Formation,* III (2009), p. 41.

[34] M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration,* cit., pp. 123-125.

[35] R. Baldwin, *The economics of European Integration*, cit., pp. 21-24.

internal market - shifting from a common market to a single one - by promoting the ‘’Single Market Program’’, which culminated then in the Single European Act (SEA), in Luxembourg, in 1985, signed by all the member states by 1987. The key changes by means of this act were intended to strengthen the four freedoms concerning the free movement of goods, services, peoples and capitals by harmonising and liberalizing goods trade and factors trade – a process that had to be completed by the end of 1992[36]. Furthermore, the most important aspect of the Single Market Program was, for sure, the attention given to capital mobility, whose completion was highlighted by means of a Council Directive in 1988[37].

The SEA introduced major procedural changes in the European Parliament for enhancing political cooperation and coordination but it also set the conditions for moving towards an Economic and Monetary Union (EMU)[38].

The Single European Act, being recognized as one of the most important steps in European integration after the Treaty of Rome, guaranteed a stronger and tighter economic integration among European Members threatening in this way those who were still not part. Indeed, it established the biggest market and trading units where every form of protectionism and controls were broken down. However, the most brilliant result related to the desire of promoting the creation of an economic and monetary union as one of the key objectives. It aimed at enhancing both cohesion and cooperation among member-states by bridging the gap between the diverse regions with the scope of avoiding the rise of ‘two-speed’ or ‘multi-speed’ Europe[39].

Cohesion became crucial point for solving inequalities and disparities among member states on the assumption that by creating only new jobs and new mobilization, the ‘’wealth-gap problem’’ would have not been fully resolved[40].

---

[36] Art. 13: «The Community shall adopt measures with the aim of progressively establishing the internal market over a period expiring on 31 December 1992 […]. The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty". Single European Act, Official Journal of the European Communities, L 169/1 [1987].

[37] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, Official Journal, L178/5 [1988].

[38] R. Baldwin, *The economics of European Integration*, cit., pp. 25-27. The SEA brought significant and major procedural changes, introducing a qualified majority voting (QMV) and abandoning the unanimity procedure for internal market regulations and decisions. This provision was taken with the idea of avoiding deadlocks in decision-making. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration*, cit., p.127.

[39] Art. 130a: «In order to promote its overall harmonious development, the Community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular, the Community shall aim at reducing disparities between the various regions and the backwardness of the least-favoured regions». Single European Act, Official Journal of the European Communities, L 169/1 [1987].

[40] Promoting cohesion was an initial attempt to solve the inequalities and differences among the member states. Yet, by strengthening economic relations within the EEC, the wealth-gap among the states became more evident. By considering the GDP in the 1960s, it was four times greater in the richest regions than in the poor ones. The situation even worsened when Britain, Ireland and Greece joined the EEC stressing more the gap

The EFTA governments reacted promptly to the Single Market Program by applying for membership, such as Austria, or by establishing bilateral agreements. However, the solution came once again from Jacques Delors with the proposal of the European Economic Area (EEA) that implied an extension of the Single Market to the EFTA countries, at the same time committing them to accepting the future European legislation with regards to the Single Market. By the end of hard negotiations, Austria, Finland, Sweden, Norway and Switzerland had applied for their membership, even though, in the end, Switzerland rejected the EEA, in 1992, definitely abandoning the application. The remaining four countries joined the EEA, with Norway rejecting again the application for the EU membership in a referendum.

The Single Market, the EEA and plans for a monetary union emerged in turbulent and chaotic years, dominated by the collapse of Communism, the unification of West and East Germany and the re-establishment of democratic governments in those countries previously led by communism. The EEC reacted promptly by exploiting these substantial political changes and proposing a further step in the European economic integration towards the creation of a monetary union, which in the eyes of Jacques Delors would have led also to a political integration[41].

1.1.4. The tough transition: Reuniting Eastern and Western Europe

During the 1990s, significant geopolitical changes occurred such as the fall of the Berlin Wall in 1989 and the consequent collapse of the Communist system. These two events brought a political shock worldwide and raised considerations over a possible reunification of Germany. Even though it brought an ambiguous enthusiasm, it scared France, Britain and Italy due to its immense size.

Morever, once Communism collapsed, the Central and Eastern European States (CEESs) realized that establishing trade agreements with the EEC was a real necessity in order to have direct access to free trade and the single market. Hence, the CEECs expressed their interests and determination in joining the process of European integration and cooperation convinced of the fact that they would have been protected from the political turmoil and economic instability.

Nonetheless, being the EEC initially reluctant and hesitant, it preferred to opt for the establishment of an *Association Agreement*[42]. This agreement included, in 1991, Poland, Hungary and Czechoslovakia

---

among the states. Therefore, economic assistance under the form of *structural funds* started to be provided. As a result, in 1974, the European Social Fund (ESF) was introduced with a focus on employment, youth employment and job creation. Similarly, in 1975, the European Regional Development Fund (ERDF) was set up to fight regional disparities and inequalities among European regions and states as they were a hinder to further expansion and integration of the economic activity. J. McCornick, *Understanding the European Union*, cit., p. 78.

[41] R. Baldwin, *The economics of European Integration.* cit. pp. 27.

[42] *Association agreements* or *Europe Agreements* are bilateral agreements between the European Union and a third country - in this case the Central and Eastern European Countries - established on the basis of the current Art. 217 TFEU (former 310 TEC). These agreements are fundamental in providing the legal framework for the accession of these third countries to the European Union. European Neighbourhood Policy And Enlargement Negotiations, Association Agreements, https://ec.europa.eu/neighbourhood-

and was then further expanded to Bulgaria, Albania and Romania, in 1994, introducing a strong bilateral partnership based on free trade, removals of barriers and restrictions with the goal of pursuing economic freedom. Furthermore, by adopting these measures, the former communist countries were able to set efficient market economies and ease the shift from a planned economy to a liberalised one. Indeed, these reforms were promoted by the desire of the CEECs to become members of the EEC. Nonetheless, this reality was still a far goal, since most Western European countries were still reluctant in welcoming the former communist countries due to their economic nature, still poor and agrarian. By the time, the Eastern enlargement was perceived as a real threat[43].

This reluctance was overcome, in June 1993, when in a conference held in Copenhagen, besides recognizing the fact the CEECs would have become members of the European Union starting from 1st of April 2004[44], the Copenhagen Criteria were introduced[45].

Throughout these years, enlargement expanded also to other Western European countries when Austria, Sweden, Norway and Finland applied for the European Union and joined successfully in 1995, except for Norway because of another national referendum[46]. Similarly, Switzerland, that had initially considered the application for membership, rejected the idea of joining in the end. Finally, also Cyprus opened her negotiation in 1996 and joined successfully in 2004[47].

---

enlargement/policy/glossary/terms/association-agreement_en, updated on the 6th December 2016, consulted on the 16th September 2018. Moreover, according to R. Schütze, association agreements «*come close to partial and passive form of Union membership*» as these treaties established a privileged relationship with the European Union. Indeed, they allow a third country to participate in the European Union system to the extent that they extend the Union law to non-member states. R. Schütze, *European Union law*, cit., p. 902.

43 R. Baldwin, *The Economics of European Integration*, cit., p 31.

44 Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia joined the current European Union in 2004, followed by Bulgaria and Romania in 2007. European Union, The 28 member countries of the EU, https://europa.eu/european-union/about-eu/countries_en#tab-0-1, updated on the 2nd July 2018, consulted on the 16th September 2018.

45 The *accession criteria* (or *Copenhagen criteria*) established the requirements and conditions that all candidate countries must fulfil to become an EU member-state. These are based firstly, on political criteria and in particular, on the stability of institutions, which shall ensure democracy, the rule of law and human rights; secondly, on economic criteria and, especially, on the need of a functioning market economy able to deal with competition and market forces and lastly, on the acceptance of *Community Acquis*, namely the acceptance of all the Treaties and EU rules as well as norms and the ability to assume the obligations deriving from membership. European Neighbourhood Policy And Enlargement Negotiations, Accession Agreements, https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/accession-criteria_en, updated on the 6th December 2016, consulted on the 16th September 2018.

46 Finland and Austria were included by 1995. Since they had direct access to the EU market through the EEA, they wanted to become full members being their product exposed to norms, regulations and standards of the EEC. In this way, they would have gained an influential voice, being able to participate in decisions and protect their national interest. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration*, cit., p. 128.

47 J. McCornick, *Understanding the European Union*, cit., p. 81.

Being a full member of the EEC, states were better able to protect their interests and take part in the decision-making about laws that would have anyway affected them, even though they decided to remain outside the EEC[48].

PART TWO

The origins of the European monetary integration

1.2. From Bretton Woods to The Hague Summit

The history of European integration can be traced back to the end of the Second World War when efforts to rebuild a Europe - destroyed and devastated by the war - started being considered. In this framework, the concept of a monetary unification was still a far reality due to the changes and due to the measures taken in the international monetary system. As a matter of fact, countries adopted primarily national monetary reforms. Specifically, France and Germany adopted policies based on stable exchange rates, price stability, control of inflation and independence of the central banks that would have become the basis on which the European monetary integration would have been built.

Some initiatives and plans for the creation of an economic and monetary union started being elaborated from the 1950s and 1960s without finding a solid ground at a political level because of the fixed exchange rate system imposed by Bretton Woods[49].

With the establishment of the Rome Treaty, signed in 1957, the EEC members acknowledged that stable exchange rates were essential for a well-functioning common market. As a result, with the aim of preserving equilibrium and continuing enjoying the benefits of the Common Market, a Monetary Committee for coordinating and monitoring economic policies among the Member States was established[50].

---

[48] Neighbour countries that were not members of the EEC were anyway affected by regulations, standards and law of the EEC without having a voice for protecting their interests. By joining and accepting the *aquis communitaire*, a member-state obtains automatically an influential voice in the decision-making process. M. J. Dedman, *Development of the European Union 1945-95 – A history of European Integration*, cit., p. 129.

[49] The Bretton Woods System was the system for monetary and exchange-rate management. This was founded in 1944, at the United Nations Monetary and Financial Conference, held in Bretton Woods. Following the negotiations and the agreement, it was decided that currencies had to be pegged to the gold price while the US dollar had to function as a reserve currency directly linked to the price of gold. Ensuring a foreign exchange rate system, hindering competitive devaluations and enhancing a solid economic growth were the key objectives of the agreement, whose primary designers were John Maynard Keynes and Harry Dexter White. In addition to, the agreement introduced a further condition such as the convertibility of the currency for trade and account transactions, which became effective and functional in 1958. As a matter of fact, countries that wished to convert currencies were required to settle international balances in dollars while US dollars were declared fully convertible to gold. Key responsibility of the US was to keep the price of gold fixed, where the exchange rate was set at 35$ per ounce while adjusting dollars supply. Investopedia, Bretton Woods Agreement, https://www.investopedia.com/terms/b/brettonwoodsagreement.asp, consulted on the 16th September 2018.

[50] See. Art. 105 and Art. 107. Treaty establishing the European Economic Community, Official Journal, [1957].

Following the failures of the European Political Community (EPC) and of the European Defence Community (EDC) in the 1950s, the founders and the architects of the European integration readdressed the political project toward an economic integration. By merging six national economies into one cohesive and integrated economic area, they aimed at creating an ever closer and more cooperative union as a way for re-establishing peace and prosperity in Europe on the basis of the *Community Method*[51].

The initial economic integration step was already laid out in the Treaty of Rome. The European economic plan would be based on the creation of a customs union and a common market respecting the free movement of goods, services, people and capital where stable currencies would have been the norm[52]. The very basis of the Treaty of Rome relied on the creation of a unified economic area where the exchange rates of the members were pegged to the US dollar. The stability of exchange-rates was secured while a specific provision for an institutional arrangement for the European currencies was neither necessary nor urgent[53].

It was only from the 1960s that national states, leaders and authorities started moving considerations in favour of a European Monetary integration. This coincided with the persistent pressures and strains exercised on the Bretton Woods System, where the US were suffering from high account deficits and rising inflation. Driven by this tumultuous and unstable scenario, the US President Richard Nixon would have opted for the suspension of the Bretton Woods system in August 1971[54].

In the same period, the Deutsche Mark suffered from depreciation, starting from 1961, which led leaders and countries to evaluate a possible monetary cooperation. To find an initial solution, EEC members opted for the adoption of different economic policies that put much more tension on the system and risked threatening the stability of the customs union and common market.

These exchange-rate tensions and pressures endangered seriously market organization established within the European Community that was based on fixed parities. Among the European leaders, the

---

[51] R. Baldwin, *The economics of European Integration,* cit. p.48. The *Community Method* is a decision-making procedure and approach for adopting common solutions for a common problem while guaranteeing a more transparent, effective and democratic functioning of the European institutions.

[52] See. Art. 2 and Art. 3. Treaty establishing the European Economic Community, Official Journal, [1957].

[53] F. Mongelli, ''European economic and monetary integration and the optimum currency area theory'', *Economic Papers* 302, (2008), p. 9.

[54] In the early 1960s, the Bretton Woods System of fixed exchange rates created a situation of overvaluation of the dollar against gold. This situation was further worsened by the increase in domestic spending for financing both Social Programs and the military expenditures in Vietnam. The strong value of the US gradually led to the collapse of the system, which was dismantled between 1968 and 1973. Throughout the 1960s the dollar had struggled for keeping the parity imposed at Bretton Woods. By 1971, the US was left with few non-gold reserves and only 22% gold-coverage of foreign reserves leading to current account deficits and anti-free-trade sentiments. As a result, the US President Richard Nixon took the decision of suspending the dollar's convertibility into gold on the 6th August 1971. Attempts to re-establish fixed exchange rates failed and by 1973, the dollar was let to float following the market price. Being the currencies initially pegged to the dollar, all the major currencies began to float against each other. IMF, The end of the Bretton Woods System (1972–81), https://www.imf.org/external/about/histend.htm, consulted on the 28th January 2019.

exchange-rate issue became the priority and a subject of broad and current interest[55]. Already by 1968-1969, it was evident that an era dominated by currency instability was on the horizon. The international disorder caused a forced revaluation of the Deutsche Mark to the extent that, in 1969, the German Government was forced to abandon the official exchange-rate, and a devaluation of the French Franc[56]. Against this troubling and unstable background and being concerned with the situation, the Community held a Summit, in The Hague, whose main focus concerned the exchange-rate issues.

1.2.1. The Hague Summit

The Hague Summit, held on the 1st and 2nd December 1969, is acknowledged as a very important and decisive moment in the process of the European integration under the hopes of completing the market, enlarging the membership and deepening the policies following the premises of the Barre Report presented on the 12th February 1969 for a greater economic coordination. This document settled the ground for the Community to apply economic policies and monetary support[57].

The reasons why economic and monetary integration played such a great role in this summit are different and diverse. Driven by the need of completing and consolidating the market, which was moving toward the last stage (establishment of customs union and common policies in trade and agriculture) on the 1st January 1970, monetary instabilities had to be solved. If not, the Common Market could have been negatively affected and eventually, dismantled[58].

---

55 H. Tietmeyer, ''From the Werner Report to the Euro'', Pierre Werner Lecture, Luxembourg, 21st October 2003, p. 4.

56 European Commission, *One Currency for one Europe: The road to Euro*, Luxembourg, Publications office of the European Union, 2015, pp. 2-3.

57 Being worried about the European solidarity and the international shock, the Vice-President responsible for Economic and Financial Questions, Raymond Barre, prepared a confidential paper looking for a further development and closer monetary relations between the Member States. He stressed the need to adjust exchange rates, abolish margin of fluctuations and introduce a mutual aid system. Being extremely cautious, he excluded the possibility of introducing or establishing a European reserve currency. On the contrary, he emphasized the priority of coordinating economic policies where the economic union would have culminated in a monetary union. The Barre Plan, presented in 1969, recognized the strong need of aligning economic policies and cooperating more in the monetary field for increasing and intensifying European economic integration. Misalignment and incompatibility of policies would have brutally harmed the custom unions. CVCE, The first and second Barre Plan, https://www.cvce.eu/obj/the_first_and_second_barre_plans-en-a27c0587-77ad-479e-a644-cb56dbaf9c90.html, last consulted on the 16th September 2018.

58 Throughout the 1950-1960s, UK experienced trade deficit, weak domestic economy due to a declining and less competitive productivity and finally, run out of gold and foreign reserves to repay back its creditors. Especially, due to an increasing cost of petrol caused by the Six-day war (1967), the global economic growth slowed down. As a result, UK suffered from increasing cost on imports, weak domestic demand, lower exports and higher unemployment. Initially, the British government reacted by cutting interest rates from 6.5% to 5% causing a worsen outcome: higher deficit, lower growth, rising unemployment and discouraged investors. In 1967, the British government had no choice but to devalue the pound sterling by 14%. The National Archives, The 1967 devaluation of the pound, http://www.nationalarchives.gov.uk/cabinet-office-100/the-1967-devaluation-of-the-pound/, consulted on the 25th November 2018. Similarly, in 1968, due to

The integration of a monetary system was interpreted, firstly, as an answer to the global monetary system, dominated by the US dollar in the Bretton Woods System and, secondly, as a way for gaining more acknowledgment in international relations by forming a compact and solid monetary entity. The creation of a monetary union would have helped define the progress and cooperation towards a political union as well[59].

The Benelux States and Italy were extremely attracted by the idea of promoting a further integration of Europe. Moreover, this plan was highly supported by two important figures elected at the time, George Pompidou and Willy Brandt, who both intended to relaunch the European integration in a more amicable context[60].

The Hague Summit showed a new attitude and approach towards the deepening of the Community, relying on stability, growth and development of cooperation towards the harmonization of economic policies, emphasized by the Final Communiqué[61].

The final outcome of The Hague Summit was extremely positive as it opened the way for building a united and cooperative Europe. As a matter of fact, on the 6th March 1970, a working *ad hoc* group chaired by the Luxembourgish Prime Minister, Pierre Werner, was settled with the aim of conducting a study on how to achieve an economic and monetary union. However, before starting the work, Belgium, Germany and Luxembourg made their considerations over the implementation which opened a debate over two different positions to be adopted: on the one hand, a monetarist approach and on the other, an economic approach[62].

---

social unrests and strikes, the French Government had to make concession in terms of higher wages and social benefits, which resulted in an explosive inflation. This event had a double effect: on the one hand, deficit in the balance of payments and on the other, lower confidence in the French currency, spreading rumours about a feasible devaluation. Hence, on the 8th August 1969, the French Prime Minister decided to devalue the French Franc by 12.5% as French economy was badly hit by inflation. This decision influenced immediately the Deutsche Mark causing its revaluation by 9.3% and leading to a situation of panic and anxiety. Hamburg Institute of International Economics (HWWA), ''French Franc devaluation: A first step towards realignment?'', *Intereconomics*, IV, IX (1969), p. 268.

59 E. Danescu, ''The Werner Report of 1970: a blueprint for EMU in the EU?'', Panel on ''Architects of the Euro'', Miami, May 2017, pp. 4-5.

60 George Pompidou was elected in 1969 as President of the French Republic, after the government led by Charles de Gaulle. By adopting a different approach compared to the former president, his primary objective was to give a significant impetus to the European integration. Therefore, he proposed to hold The Hague Summit under the assumption of enhancing policies on completion, deepening and enlargement of the EEC. Similarly, the Chancellor of the Federal Republic of Germany, Willy Brandt, was keen to promote and stimulate cooperation with France. From his point of view, this dual-axis was a vital and fundamental element for further steps and progress in the Community. *Ivi*, pp. 5-6.

61 «[8]. The integration process should result in a Community of stability and growth. To this end they agreed that […] a plan in stages should be worked out during 1970 with a view to the creation of an economic and monetary union. The development of monetary co-operation should depend on the harmonisation of economic policies». CVCE, Final communiqué of the Hague Summit (2 December 1969), https://www.cvce.eu/content/publication/1997/10/13/33078789-8030-49c8-b4e0-15d053834507/publishable_en.pdf , consulted on the 16th September 2018.

62 E. Danescu, ''The Werner Report of 1970: a blueprint for EMU in the EU?'', cit., pp. 7-8.

1.2.2. The Franco-German clashes and controversies: Monetarists vs. Economists

The process toward the European monetary and economic integration was challenged by debates, ideological clashes and negotiations over the method to be used for the integration process among the experts composing the Werner Group. As a matter of fact, the EMU should have been seen also as a process of understanding and compromises among different economic policy-making, conceptions of the state and monetary integration to the extent that two opposing and contrasting points of view emerged.

The *monetarist* approach, highly supported by France, relied on the crucial role played by *ad hoc* institutions, the need of introducing requirements to be met and, finally, a coordination of economic policies[63]. The monetarists were promoting the introduction of measures on exchange rate stability and exchange rate support mechanism. They claimed that applying rules of conduct was the only way to give credibility to the monetary union and constrain the behaviour of the actors involved[64]. They advocated much more attention on institution-building and on the monetary integration as a way for achieving a convergence progress among the countries. Both France and Belgium were strong supporters of monetarism being more concerned about taking concrete decisions on currency-fluctuations.

On the other hand, the *economist* approach was championed by Germany and countries with strong currencies. They emphasized the coordination of economic policies, seen as vital and fundamental for promoting a long convergence process towards an alignment of monetary policies. According to this approach, a solid economic and monetary union rested on convergence of economic performances which precedes the establishment of the institutions. The *economist* approach also intended to minimize negative and dysfunctional risks deriving from highly-inflated countries.

In conclusion, the *economist* approach conceived the economic integration as a process based on stability, convergence and harmonisation of policies which could lead to the introduction of a single currency. This second approach was highly supported by the German Plan or *Schiller Plan*[65]. Even

---

[63] *Ivi*, p. 23.

[64] F. Mongelli, ''European Economic and monetary integration and the optimum currency area theory'', cit., p. 10.

[65] German position on European monetary integration was presented by the Minister of Economic Affairs, Karl Schiller, on the 12th February 1970. The *Schiller Plan* envisaged a process divided into four different phases where the first two were the most important since they were focused on harmonising economic, monetary and fiscal policies and introducing a mechanism for balancing disequilibria in the balance of payments. Only in the third phase, elements such as reduction of margin fluctuations, changes in parity and the creation of a European Reserve Fund could be adopted. It was supposed that, in this third phase, the European economies would have converged. On the contrary, vague and indefinite considerations were presented for fixed exchange rates and the creation of a Central Bank. CVCE, The emergence of a plan for an economic and monetary union, https://www.cvce.eu/en/education/unit-content/-/unit/d1cfaf4d-8b5c-4334-ac1d-0438f4a0d617/542a8508-f911-4c0f-9d3c-11b27ab43ef3, consulted on the 16th September 2018.

though in favour of a monetarist approach, Pierre Werner had to keep a neutral position. As a result, he opted for a «*parallel approach to economic cooperation and monetary coordination*»[66].

1.2.3. The Werner Report

The work of the Werner Group was conducted starting from the beginning of 1970 and was presented on the 7th October 1970. This report conveyed a general picture and framework over the measures and steps towards an economic and monetary union (EMU)[67].

The establishment of the EMU would have not been immediate and rapid but, on the contrary, it would have passed through an evolving and gradual process while relying on economic coordination and monetary cooperation. As a matter of fact, the Werner Report proposed an incomplete action plan to be divided into three different stages. On the one hand, it did not specify a precise timetable or deadlines so as to maintain a flexible approach. On the other hand, it did not give enough considerations to the political and institutional structures[68].

At the very basis of the Werner report, there was the wish to identify some conditions and the minimum that had to be done for the establishment of the monetary union. The main scope of the process moved around the promotion of four freedoms – goods, services, people and capital– without exchange-rate risks[69]. Yet, it was also required to apply coordination, harmonization of the policies

---

66 CVCE, Economists v. monetarists - agreements and clashes in the drafting of the Werner Report, https://www.cvce.eu/content/publication/2012/4/3/875a85f1-e099-4013-acbf-68b2c50a6879/publishable_en.pdf, consulted on the 16th September 2018.

67 Before the final report, an interim report was presented being the product of the first meetings of the Werner Group, which were held between the 11th March and 20th of May 1970. This was submitted to the Finance Ministers Meeting, held in Venice on the 29th May 1970. This Interim Report studied the basic conditions for the establishment of EMU by stages as it was proposed by the Werner Group. However, as it was stressed by Pierre Werner, further work had to be done by focusing on some priorities, such as institutional aspects, the definition of some effective instruments for guaranteeing coordination of short-term and medium-term economic policy, harmonisation of monetary policy and credit policy instruments. These proposals were appraised by the Council to the extent that they voted in favour of continuing the assesment. As it was already expressed in the Interim Report, a transfer of sovereign power from the national to the Community level would have been required. Similarly, the Report presupposed changes and amendments concerning the Treaty of Rome. As it follows: «Sur le plan des réformes institutionnelles, la réalisation de l'union économique et monétaire exige la création ou la transformation d'un certain nombre d'organes communautaires auxquels devront être transférés des attributions jusque-là exercées par les autorités nationales. Ces transferts de responsabilité impliquent le développement de la coopération politique dans les différents domaines. [..]. Les réformes institutionnelles nécessaires supposent une modification des dispositions du Traité de Rome dont il importe de mener à bonne fin les travaux préparatoires dès la première étape». CVCE, Rapport intérimaire au Conseil et à la Commission concernant la réalisation par étapes de l'Union économique et monétaire (Luxembourg, 20 mai 1970), https://www.cvce.eu/obj/interim_report_to_the_council_and_the_commission_on_the_achievement_by_stages_of_economic_and_monetary_union_luxembourg_20_may_1970-en-fd977fc3-548f-42df-b79a-628d952633ae.html, consulted on the 16th September 2018.

68 I. Maes, ''On the Origins of the Franco-German EMU controversies'', *European Journal of Law and Economics*, XVII (2004), p. 14.

69 As it is written in the Report: «Economic and monetary union will make it possible to realize an area within which goods and services, people and capital will circulate freely and without competitive distortions,

and lastly, the introduction of common policies. Besides this, also the introduction of a single and sole currency and the transfer of economic policy power from the national to the Community level were demanded[70].

The report provided general guidelines and plans for the establishment of an economic and monetary union distributed over a ten-year-period. Driven by the principle of *parallel movement in practice* towards economic policy convergence, the *Werner Plan* tried to give enough attention to the introduction of monetary constraints; transfer of power with regards to economic and monetary policy and lastly, development of Community powers and effective European institutions[71]. By considering the conclusion in the Werner Report, the creation of the monetary union could be realized within a decade, it being a source of growth and stability[72].

The **first stage** envisaged the reduction of exchange rate fluctuations and the beginning of a process for coordinating monetary and fiscal policies. After this step, **the second phase** would have ensured an economic consolidation by reducing inflation-differentials and exchange-rate differences. Finally, **the third step** would have been characterized by the irrevocable fixing of exchange rates, removal of capital controls and the establishment of a system supervised by a European Central Bank - accountable for monetary policy - and balanced by a closer coordination of fiscal policy at European level[73].

Soon after the publication, the Werner Report was highly and heavily criticized as the transfer of powers and the introduction of a supranational structure were considered sticking points by France. However, the Six adopted a political resolution, with no political legal force, on the 22nd of March 1971, containing general considerations, goals and suggestions for improving the economic and monetary union.

---

without thereby giving rise to structural or regional disequilibrium». Council and Commission of the European Communities, ‘’Report to the Council and the Commission on the realization by stages of economic and monetary union in the Community «Werner Report»’’, *Bulletin of the European Communities,* XI (1970), p. 9.

70 As it follows in the Report: «A monetary union implies inside its boundaries the total and irreversible convertibility of currencies, the elimination of margins of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital. [..]. From the technical point of view the choice between these two solutions may seem immaterial, but considerations of a psychological and political nature militate in favour of the adoption of sole currency which would confirm the irreversibility of the venture. [..]. To ensure the cohesion of economic and monetary union, transfers responsibility from the national to the Community plane will be essential». *Ivi*.

71 E. Danescu, ‘’The Werner Report of 1970: a blueprint for EMU in the EU?’’, cit., p. 22.

72 VII. Conclusions [A]: «Economic and monetary union is an objective realizable in the course of the present decade provided only that the political will of the Member States to realize this objective, as solemnly declared at the Conference at The Hague is present. The union will make it possible to ensure growth and stability within the Community and reinforce the contribution it can make to economic and monetary equilibrium in the world and make it a pillar of stability». Council and Commission of the European Communities, ‘’Report to the Council and the Commission on the realization by stages of economic and monetary union in the Community « Werner Report »’’, cit. p. 26.

73 K. Gaynor, E. Karakitsos, *Economic Convergence in a Multispeed Europe*, Houndmills, Basingstonke, Hampshire and London, Macmillan Press LTD, 1997, p. 8.

Nevertheless, in the context of the 1971-crisis of the Bretton Woods System, the target of creating the EMU received less attention and became less binding[74]. Indeed, the surprising decision of the US President, Richard Nixon, threatened both the whole European project and the ambitions laid out in the Werner Report which were further weakened by the global political framework and volatile exchange-rates. The situation was even further complicated by national governments still reluctant to give up their monetary sovereignty and national economic objectives.

As a consequence, the first attempt to build a monetary union reversed into a failure showing also the intrinsic weaknesses of this project. The European Monetary and Economic Union, as it was conceived by the Werner Group, was established upon fixed but adjustable parities. Moreover, the project was extremely vague with regards to the second and third steps of the EMU having provided only general guidelines.

Nonetheless, the Werner Report marked a crucial step in the European integration whose credits and merits would have been stressed in the Delors Report, in 1989. The Werner Group should be praised for having provided elements and principles that were considered fundamental for moving towards an economic and monetary union. Three elements strongly supported the Werner report: firstly, the need of a step-by-step approach for the realisation of the EMU; secondly, the need of economic convergence and lastly, the transfer of power to a supranational authority[75].

1.2.4. Europe trapped in a ''snaky'' tunnel: The European Monetary System (EMS)

The end of Bretton Woods signalled the end of an era with regards to the international monetary system. This shocking event brought Europe and, specifically, the EEC to take important and significant decisions during the 1980s that subverted completely the system and changed forever European politics and economics. As a result of the Smithsonian Agreement, which occurred in December 1971, important steps were taken at a regional level for enhancing exchange rate stability[76]. As a matter of fact, the ''*Snake in the Tunne*l'' was formed, in March 1972, as a mechanism for managing and dealing with the fluctuations of the European currencies within specific narrows limits

[74] H. Tietmeyer, From the Werner Report to the Euro, cit. p. 7.

[75] E. Danescu, ''The Werner Report of 1970: a blueprint for EMU in the EU?'', cit., pp. 1-9.

[76] The Smithsonian Agreement was a temporary agreement negotiated, in December 1971, in Washington, among the ten leading developed countries – the Group of Ten (G-10) – represented by Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States. The Agreement envisaged a solution for supporting the trembling Bretton Woods System by re-introducing a pegged system even though with significant changes. The currencies were allowed to fluctuate by 2.25% around the dollar which was devalued by 7.9% as a result of the price increase of gold up to 38 dollars. By taking this decision, repercussions were highly felt in Europe as the European currencies could fluctuate up to 4.5% against each other by means of the new fluctuations bands and new measures adopted. Certainly, this created a high pressure that could have come to the detriment of the Common Market. E. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe,* cit., p. 8.

set up to 4.5% - the snake - while as a whole they would have fluctuated within 2.25% against the dollar – the tunnel[77].

Yet, this system lasted only until 1973 because of the oil crisis, which compromised the stability of the agreement, aggravated by policy divergences and the dollar's weakening. However, the "European Monetary Snake" was also strongly hit by major problems as some currencies, such as the Sterling and the Lira, were forced to abandon the system earlier. The *Snaky Tunnel* left nothing but a *''Deutschmark Zone''* – it being the most stable currency – including also Denmark and the Benelux countries. Born to keep stability and solid exchange-rates, the Snake failed in its duty. Similarly, the commitments agreed in the Werner Report - coordination of monetary policy and stable exchange rates - were abandoned[78].

Despite being a true European initiative based on collaboration and coordination, the failure of the *Snake in the Tunnel,* accompanied by the 1973-oil-shock, put an end to the *Golden Age* that had characterized the previous years. On the contrary, it was the beginning of a period dominated by *stagflation* – high inflation, slow economic growth, dreadful unemployment and economic stagnation.

Yet, the quick death of the snaky tunnel did not diminish the interest of moving towards the creation of a solid and compact monetary union. This is also confirmed by the words and speech of the former President of the European Commission, Roy Jenkins, in 1977, who put forward a more limited proposal for the creation of an Economic and Monetary Union[79].

As a matter of fact, by March 1979, the European Monetary System (EMS) was introduced, involving all the European currencies, except for the Sterling, being British influenced by a feeling of cynicism on behalf of banks and economists[80]. On the contrary, European leaders were extremely willing to re-

---

[77] European Commission, *One Currency for One Europe – The Road to Euro,* cit., p. 3.

[78] K. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe,* cit. pp. 8-9.

[79] On the 27th October 1977, the former President of the European Commission, Roy Jenkins, held a speech concerning the establishment of a European Monetary Union at the European University Institute (EUI). By presenting the EMU as the best way to enhance economic growth and overcome inflation and unemployment, he thus stated: «We must now look afresh at the case for monetary union because there are new arguments, new needs, and new approaches to be assessed, which go to the heart of our present apparently intractable problems of unemployment, inflation and international financing». R. Jenkins, ''Europe's present challenge and future opportunity'', First Jean Monnet Lecture, European University Institute, Florence, 27th October 1977, p. 10.

[80] Roland Vaubel, an important German economist, expressed his disappointment towards the establishment of the European Monetary System (EMS) as he was convinced of the fact that this new scheme was a pure continuation of the former *Snake in the tunnel,* where the French franc, the Italian Lira and the Ireland Punt were returning to a sort of 'snake-type adjustable pegged system' being exposed to a constant asymmetry. However, he acknowledged that the EMS was an attempt to defeat European inflation by bringing it at the German level which would have simply resulted in higher unemployment. Finally, he was so reluctant and opposed to the EMS that he was convinced of the fact that this new system would have resulted, at least for the first years, in large interventions and new controls on trade and capital. As he claimed: «Once it is realized that snake-type exchange rate systems presuppose the hegemony of one currency, it becomes that, however voluntarily such a scheme may be accepted by the smallest countries, there are strong political reasons for expecting that it will not prove operational for the Community of the Nine». D. Cobham and G. Zis, Money, Macro and Finance Research Group, *From EMS to EMU: 1979 to 1999 and Beyond,* (edited by)

establish a pegged-exchange-rate-system for guaranteeing the stability and the correct functioning of the European Common Market, which was based on stable exchange rates.

In this regard, the EMS should be considered as an attempt at exchange-rate cooperation, built around the concept of stable but adjustable bilateral exchange rates settled in relation to the newly created European Currency, the ECU[81]. Moreover, being the exchange rate volatility considered as unacceptable and inadmissible, an exchange rate mechanism (ERM) was introduced to guarantee exchange rate stability while limiting and reducing fluctuations[82]. Specifically, the currency fluctuations had to be contained within a margin of ± 2.25% around the declared central parity, except for the Italian Lira and the Pound Sterling, which could fluctuate by ±6%. In addition to this, member states were committed to intervene and defend the parities whenever it was necessary. Similarly, decisions had to be taken unanimously when existing parities would need to be revised and eventually, changed[83].

The EMS should be acknowledged as a first attempt to move towards monetarism drifting apart from Keynesianism, where the ERM stood as a real commitment for achieving price stability.

1.2.5. The phases of the Exchange Rate Mechanism (ERM)

The Exchange Rate Mechanism (ERM) is a system characterized by three different phases: the first phase started with the introduction of the EMS in March 1979 and lasted until March 1983. This was marked by frequent realignments, insufficient policy coordination and low-convergence in key macroeconomic variables.

From March 1983 until January 1987, the second phase took the lead being affected by consolidation, lower and decreasing inflation differentials and, finally, fewer realignments, speculative attacks and the introduction of capital controls[84]. This second phase created a sort of indeterminacy in the system

---

D. Cobham and G. Zis, Houndsmills, Basingstoke, Hampshire and London, MacMillan Press LTD, 1999, p. 54.

81 The European Currency Unit (ECU) was a basket currency based on a weighted average of the twelve EMS currencies - the Belgian franc, the German mark, the Danish krone, the Spanish peseta, the French franc, the British Pound, the Greek drachma, the Irish pound, the Italian lira, the Luxembourgish franc, the Dutch guilder and the Portuguese escudo. Specifically, it was the official monetary unit, an accounting unit, of the ESM before the introduction of the Euro, whose value was then used to determine and define the exchange rates and reserves among the members of the EMS. Investopedia, European Currency Unit (ECU), https://www.investopedia.com/terms/e/european-currency-unit.asp, consulted on the 16th September 2018.

82 European Commission, *One currency for one Europe: The Road to Euro*, cit., p. 4.

83 C. Wyplosz, ‘’EMU: Why and How it might happen’’, *Journal of Economic Perspectives*, XXI (1997), p. 4.

84 Speculative attacks occurred because of the policies applied in several European countries. For instance, France, under the lead of the Socialist government, introduced a policy more focused on inflation control, which caused an appreciation of the French real exchange rate. The nominal exchange rate was not able anymore to counterbalance wage and price differentials. By means of this shift, a sort of vacillation of the system emerged, which could be overcome by letting country to set their monetary policy thus keeping the exchange rate target. Otherwise, another option could have been a more collaborative and cooperative approach concerning the introduction of a monetary policy for the whole system. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe*, cit. pp. 10-11.

which could only be solved through setting monetary policy to keep exchange rate stability or cooperation in applying monetary policy for the whole region.

The third phase ran from January 1987 until the beginning of 1991, being characterized by stability, inflation convergence and fewer realignments, reflected also in a narrowing of interest rate differentials (both short and long-term)[85].

By the late 1980s, the European Monetary System was considered a real success having provided a fair balance and great economic stability after the turbulent years post-Bretton-Woods[86]. Furthermore, this prosperous period coincided with the Single European Act (1986) which brought a more collaborative approach and agreement through the introduction of common aims and objectives.

Being the aim of the SEA, the creation of a Single Market by the end of 1992, this agreement not only brought to a sort of deadlock on how to proceed, but it also brought to light a serious and major problem: the incompatibility between free trade requirements and the detrimental realignments of the exchange rates. Thanks to the Council Directive 88/361/EEC, member countries removed capital controls providing the right framework for a single financial market in Europe[87].

By removing controls among the members, a destabilizing effect did not occur immediately thanks to an important agreement signed in 1987, the Basle-Nyborg Agreement, which contributed to bringing more credibility to the EMS and to the ERM[88].

In the wake of the success of the EMS and ERM, European leaders had not realized that by removing capital controls, they were basically giving up their national monetary policy independence in favour of one country: Germany[89].

Considering this new phase of the ERM, it was characterized by decreasing convergence in both inflation and in interest rates, such as the deflationary measures exerted an even stronger and painful pressure on the system itself. Therefore, European countries reacted by introducing policies towards the re-evaluation of the currencies. Yet, the scenario was however further complicated by two intense

---

85 *Ivi*, pp. 10-14.

86 C. Wyplosz, ''EMU: Why and How it might happen'', cit., p. 4.

87 By removing capital controls among European member-states, which were already enjoying stable exchange rates under the European Monetary System, conditions for providing a further step in favour of an ever closer economic and financial integration, were set up.

88 The Basle-Nyborg Agreement, established in September 1987, marked the beginning of a new phase by further promoting coordination of economic policies and introducing credit mechanisms. This agreement, however, did not alter the scope of the EMS. Indeed, it strengthened the system by allowing access to the Very Short-Term Financing Facility (VSTFF) while promoting intra-marginal interventions. It could be carried out only with the consent of the central banks issuing the intervention currency and more movements within the bands. The VSTFF was, indeed, introduced to counterattack speculation whenever the exchange rates had reached the limit of fluctuation margins. Specifically, the agreement prolonged the duration of the VSTFF by month and convened more flexibility within the bands to contrast speculative pressures. H. James, *Making the European Monetary Union*, Cambridge, Massachusetts, London, The Belknap Press of Harvard University, 2012. p. 223-225.

89 C. Wyplosz, ''EMU: Why and How it might happen'', cit. p. 5.

episodes of currency speculations that occurred starting from September 1992 and culminated in the suspension of the Sterling and the Lira from the ERM.

Since turbulence and instability reigned throughout 1993, several countries adopted policies which put much more pressure on the system. As a result, on the 2nd August 1993, the EMS bands were expanded from 2.25% to 15% of the central rate, creating ERM II.

By responding differently to financial instabilities, the markets had created a Two-Speed Europe, where some countries – the Core - were ready to move further in the direction of a solid Monetary Union and some others – the Periphery – needed more time to converge. At this point, the EMS countries found themselves at a very important crossroad: either moving forward in the direction of a monetary union or stepping backward towards looser exchange rate bands that could compromise and badly hit the process of European integration and the Single Market.

To save the Union, the only available option was taking serious steps in the direction of the Economic Monetary Union[90]. By that time, some larger countries, such as Italy and France, had realized that by pegging their currencies to the Deutsche-Mark, they had basically lost their monetary policy independence. As a matter of fact, the only and possible way for regaining some influence and voice would have been to establish a European super-national authority that would have replaced the German Bundesbank[91].

1.2.6. The role of Germany

Germany played a crucial role in the establishment of the EMS and specifically with regards to the ERM, to the extent that different and critical views emerged over its tasks. Germany had the same or similar monetary function of the US under the Bretton Woods System. Basically, European countries pegged their currencies to the stable Deutsche Mark being forced to adapt their national monetary policy to the German one.

By the 1980s, it had become evident that the German Bundesbank was setting the monetary policy for the whole EMS countries. Small European economies aligned indeed their monetary policies with the Bundesbank's measures.

The ESM had *de facto* created a pure *Mark-Zone* due to two main elements: (1) the economic size of Germany, which further expanded through its re-unification and (2) the incredible performance of the conservative Bundesbank in fighting inflation while keeping the Deutsche Mark as a strong currency[92]. However, at the same time, German monetary policy was influenced by other important member countries, such as France.

---

[90] K. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe,* cit. pp. 15-16.

[91] C. Wyplosz, ''EMU: Why and How it might happen'', cit., p. 6.

[92] *Ivi*, p. 5.

Responses to German interest rates and its developments demonstrated that the ESM was affected by an asymmetric nature from the very beginning. Indeed, in some countries, such as Italy and France, interest rates were higher and more volatile due to the former speculative attacks[93].

The important role played by Germany augmented significantly due to the re-unification of the two sides, which had an enormous impact not only on the monetary system but also on the process of the European monetary integration[94]. Being Germany the largest European economy and also the center and the engine of the system, the country was able to influence and transfer shocks to neighbouring countries. European countries were, indeed, bound to one another through the exchange rate regime, established upon stable but adjustable rates within the EMS.

The choice to finance the re-unification on German government budget were complex and had several consequences. On the one hand, Germany acted as an engine and driving element for the Community countries. On the other, the expansion of the German economy implied an increase of interest rates due to a combination of tight monetary policy and increased government deficit. By adopting these measures, also other EMS countries suffered from a serious increase in their interest rates in order to keep their peg to the Deutsche Mark. As a matter of fact, EMS area experienced a reduction in terms of competition and in competitiveness due to the Mark appreciation, which put a halt on the other EMS economies in contrast to the non-members[95].

PART THREE

The New Era towards the European Monetary Union

1.3. Planning the EMU: The Delors Report

Conscious of the enormous success of the EMS, in June 1988, the European Council asked the Commission President, Jacques Delors, to call for a high important Summit for drawing a plan towards the ambitious creation of an Economic and Monetary Union (EMU). Jacques Delors was asked to chair a Committee with the scope of studying the necessary steps and process for promoting its evolution.

---

93 K. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe,* cit., pp. 11-12.

94 With the fall of the Berlin Wall in 1989, national reunification was invoked by the German Chancellor, Helmut Kohl. This consideration, however, risked making Germany more dominant and prominent in Europe. As a matter of fact, both the German Chancellor, Helmut Kohl, and the former French President, François Mitterand, thought that by introducing a single currency and creating an irrevocable economic currency area, a much larger Germany would have been contained on a peaceful continent. Yet, before giving up their national currency, Germany requested the creation of a European Central Bank modeled on the conservative Bundesbank, with a board to give voice to all other member states. It was highly thought that by creating a monetary union, the cross-country pressures among European financial markets would have diminished. A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, New York, Viking, 2018, p. 104.

95 K. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe,* cit., p. 15

Compared to Werner, the historical context was completely different due to the size of the EEC – it being now composed of Twelve members and not Six – and due to the divergent ideas on the goal of integration. Yet, the working-group issued an important report. As the *Werner Report*, also the new *Delors Report* suggested a plan to be divided in three important phases[96].

The former European Monetary System was praised for the goal achieved in enhancing a solid economic coordination among the member states. Yet, besides acclaiming Germany for the brilliant role and the improvements obtained through the Basle-Nyborg Agreement in 1987, the *Delors Report* stressed also the shortcomings and weaknesses of this system. Not only did it put a major emphasis on the tensions caused by the lack of convergence in fiscal policies but it also acknowledged the disrespect of the Exchange Rate Mechanism (ERM) resulting in wider fluctuations[97].

Initially, the *Delors Report* was intended to present the path towards the monetary union as a mere continuation of the Single European Act on the assumption that the Single Market could have exploited its full potential only by adopting a common and single currency. On the one hand, it would have reduced transaction costs; on the other, it would have eliminated exchange rate risks while ensuring greater transparency and economic welfare.

By the time of the EMS, European countries had already lost their monetary policy autonomy being pegged to Deutsche Mark. Therefore, in the politicians' mind, a monetary union would have contributed to share influence and gain power[98].

The *Delors Report* suggested, like the *Werner Report*, three concrete stages without clarifying a specific deadline as it was not advisable by the time. Yet, it was highly recommended to start the process no later than the 1st July 1990, following the adoption of the Council Directive 88/361/EEC on the liberalisation of capital movements[99]. The *Delors Report* drew up, in this way, the blueprint for the Maastricht Treaty that would have specified and laid out the timetable and the additional elements concerning the monetary area.

---

96 *Ivi*, p. 16.

97 As it is written in the *Delors Report*: «The EMS has served as the focal point for improved monetary policy coordination and has provided a basis for multilateral surveillance within the Community. […]. The System has benefited from the role played by the Deutschmark as an 'anchor' for participants' monetary and intervention policies. […]. At the same time, the EMS has not fulfilled its full potential. Firstly, a number of Community countries have not yet joined the exchange rate mechanism and one country participates with wider fluctuation margins. Secondly, the lack of sufficient convergence of fiscal policies as reflected in large and persistent budget deficits certain countries has remained a source of tensions and has put a disproportionate burden on monetary policy». Committee for the Study of Economic and Monetary Union, ''Report on Economic and Monetary Union in the European Community'', European Commission, Working Document (1989), http://aei.pitt.edu/1007/ , updated on the 27th May 2014, consulted on the 16th September 2018, p. 8.

98 F. Mongelli, ''European economic and monetary integration and the optimum currency area theory'', cit., p.14.

99 See point ''43. Calendar'' in Committee for the Study of Economic and Monetary Union, ''Report on Economic and Monetary Union in the European Community'', cit., p. 28.

Despite the different period in which the *Werner* and then the *Delors Report* were written down, they present some common points on the conditions to be met in a monetary union: irreversible convertibility of the currencies, complete liberalisation of capital movements supported by an integration of the banking and financial markets and lastly, the abolition of fluctuation margins of exchange rates. Beside this, they both emphasized the need to proceed through three crucial stages necessary to enhance a feasible shift towards a monetary union. In particular, the parallelism concerning the progress of the economic process and the institutional and procedural adjustments received special attention. As a matter of fact, the first two stages were seen as critical and decisive for creating the right framework while the transfer of monetary policy at a supranational level could occur only in the third stage[100].

Stage I was the initial phase of the process for the creation of an economic and monetary union. Therefore, it was concerned with favouring the convergence of the economic performance by introducing a stronger cooperation and coordination among the states. Specifically, it was highly recommended not only to complete the market by removing any barriers - physical and technical - but also to introduce a closer cooperation on macroeconomic policies. Decisions were thus taken focusing both on the economic and monetary field[101]. To avoid exchange rate alignments, it was important to include all the members in the Exchange Rate Mechanism (ERM). However, the first stage, besides introducing the new necessary steps, requested changes concerning the Treaty of Rome[102]. Amendments and modifications were needed and imperative for proceeding towards Stage II, which was concerned with the creation and setting up of new institutions: the European System of Central Banks (ESCB) and an independent central bank with the primary objective focused on price stability[103].

---

[100] H. Tietmeyer, ''From the Werner Report to the Euro'', cit., pp.14-19.

[101] See point 51. «In the economic field the steps would centre on the completion of the internal market and the reduction of existing disparities through programmes of budgetary consolidation. [..]. Firstly, there would be a complete removal of physical, technical and fiscal barriers within the Community, in line with the internal market programme. [..]. Thirdly, the 1974 Council Decision on economic convergence would be replaced by a new procedure that would strengthen economic and fiscal policy coordination and would, in addition, provide a comprehensive framework for an assessment of the consequences and consistency of the overall policies of Member State». Committee for the Study of Economic and Monetary Union, ''Report on Economic and Monetary Union in the European Community'', cit., p. 30. And see point 52. «In the monetary field the focus would be on removing all obstacles to financial integration and on intensifying cooperation and the coordination of monetary policies. [...]. It would be important to include all Community currencies in the EMS exchange rate mechanism». Committee for the Study of Economic and Monetary Union, ''Report on Economic and Monetary Union in the European Community'', cit., p. 31.

[102] See point 18. «The Treaty of Rome, as amended by the Single European Act, provides the legal foundation for many of the necessary steps towards economic integration, but does not suffice for the creation of an economic and monetary union. The realization of this objective would call for new arrangements which could only be established on the basis of a Treaty change and consequent changes in national legislations. For this reason the union would have to be embodied in a Treaty which clearly laid down the basic functional and institutional arrangements, as well as provisions governing their step-by-step implementation». *Ivi*, , p. 13.

[103] The European Monetary System of Central Banks (ECSB) was to be established with the aim of coordinating

As the *Werner Report*, also the *Delors* emphasized the vital importance of a supranational and autonomous central bank with a main difference. The former (*Werner)* privileged a federal model, on the basis of the US Federal Reserve; the latter (*Delors*) drew up its model on the German Bundesbank[104].

Stage II was to take the lead as soon as the revision of the Treaty occurred as it would introduce significant changes in the institutional framework. Being a period of transition to the final stage, Stage II had to be *a training process* requiring the accumulation of foreign exchange reserves and the regulation of the monetary and banking sectors to achieve harmonization thanks to the introduction of the EMI[105].

Finally, **Stage III** would have started with the introduction of irrevocably locked exchange rates and the sacrifice of the national monetary policy, resulting eventually in the adoption of a common single currency replacing the national ones[106].

Concerning the final and last phase, major measures would be adopted with regards to the economic and monetary field. On the one hand, regional and structural policies would have been strengthened and would have become an issue to be discussed at a European level. On the other, the macroeconomic and budgetary fields would have been dictated by means of binding rules where international policy cooperation would have operated at a European level[107].

Even though, the *Delors Report* re-evoked the *Werner Report* in terms of three-step-approach with specific measures to be adopted in each phase, the *Delors Report* is not only more precise and complete with regards to the transition period but also stricter about limiting the fiscal policy autonomy. However, even though the *Delors Report* conceived a specific plan, the process had to be considered as a single block, giving for granted that once a country decided to be part of the project, it had to complete it[108].

---

and formulating the monetary policies among the member states. Additionally, the key task of this body was to enhance the transition towards an independent national monetary policy, which had to be launched in the final stage. See ‘’point 57’’ in Committee for the Study of Economic and Monetary Union, ‘’Report on Economic and Monetary Union in the European Community’’, cit., pp. 34-35.

[104] H. Tietmeyer, ‘’From the Werner Report to the Euro’’, cit. p.16.

[105] See point 55. «Second stage could begin only when the new Treaty had come into force. In this stage the basic organs and structure of the economic and monetary union would be set up, involving both the revision of existing institutions and the establishment of new ones. Stage two must be seen as a period of transition to the final stage and would thus primarily constitute a training process leading to collective decision-making, while the ultimate responsibility for policy decisions would remain at this stage with national authorities». Committee for the Study of Economic and Monetary Union, ‘’Report on Economic and Monetary Union in the European Community’’, cit., p. 33.

[106] See point 58. «The final stage would commence with the move to irrevocably locked exchange rates and the attribution to Community institutions of the full monetary and economic competences described in Chapter II of this Report. In the course of the final stage the national currencies would eventually be replaced by a single Community currency». Committee for the Study of Economic and Monetary Union, ‘’Report on Economic and Monetary Union in the European Community’’, cit., p. 38.

[107] K. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe,* cit., p. 17.

[108] See point. 39. «The Committee agreed that the creation of an economic and monetary union must be viewed

In contrast to the *Werner Report*, which took for granted the fact that all member countries would have joined the ambitious process, the Delors Group faced some difficulties in reaching a general consensus demonstrating some disagreement and leading to an ambiguous compromise over the participation of the member states[109]. In addition to this, the economic and monetary union was considered as the result of an intricate process of progressive European economic integration where the plurality and diversity of the different countries had to be respected and preserved even after the creation of a monetary union. This is extremely important because it left open a very important question on whether and how to continue toward the direction of a political union[110].

The *Delors Report*, approved by the European Commission, was submitted on the 12th April 1989. Being well received by European member states, it was presented in the Madrid European Council, held on the 26th and 27th June 1989. During this conference, countries affirmed their determination and intention to move towards the Economic and Monetary Union.

In conjunction with the abolition and removal of capital controls, a date for Stage I was decided: 1st July 1990[111]. On the contrary, for the other dates, the European Council preferred to start negotiations for revising the Treaty[112].

---

as a single process. Although this process is set out in stages which guide the progressive movement to the final objective, the decision to enter upon the first stage should be a decision to embark on the entire process». Committee for the Study of Economic and Monetary Union, ''Report on Economic and Monetary Union in the European Community'', cit., p. 27.

[109] See point. 44. «Participation. There is one Community, but not all the members have participated fully in all its aspects from the outset. A consensus on the final objectives of the Community, as well as participation in the same set of institutions, should be maintained, while allowing for a degree of flexibility concerning the date and conditions on which some member countries would join certain arrangements. Pending the full participation of all member countries which is of prime importance influence on the management of each set of arrangements would have to be related to the degree of participation by Member States. However, this management would have to keep in mind the need to facilitate the integration of the other members». *Ivi*, p. 28.

[110] A political union is the last important stage of an integration process which involves both common home and judicial policies and a common foreign and security policy. A common policy envisaged a set of rules, decisions and measures adopted by common institutions established by a group of states and introduced by common institutions and members states. A common policy coexists with the national policies which have not been affected by decisions agreed by the common institutions. Finally, the development of common policies proceeds by fully implementing the common home and foreign agreed by the common institutions and all the participating states of policies. Europedia, Towards a political union in Europe, http://www.europedia.moussis.eu/books/Book_2/3/8/?all=1, consulted on the 16th September 2016.

[111] To introduced the Single Common Market, liberalisation was launched already in 1960, when some restrictions concerning commercial and private capital movements were removed. Yet, further steps were taken - between 1985 and 1986 - in some areas, such as long-term lending for commercial transactions and securities. However, the major and most important step arrived in 1988, by means of a Council Directive, which eliminated all the remaining restrictions by the 1st July 1990. Capital movements were, thus, fully liberalised even though some particular and specific but temporary restrictions were introduced for some countries, such as Ireland, Portugal, Spain until the 31st December 1992 and Greece until the 30th June 1994. European Parliament, Fact Sheets on the European Union – Free Movement of Capital, http://www.europarl.europa.eu/factsheets/en/sheet/39/free-movement-of-capital#_ftn3, updated in May 2018, consulted on the 16th September 2018.

What is remarkable is the fact that, both in the *Werner* and in the *Delors Report*, the transition to a single currency was never been considered a necessary and imperative step towards the monetary union. However, with the aim of binding the member countries in an irreversible process, the states moved in this direction[113].

1.3.1. Building the Economic and Monetary Union: The Maastricht Treaty

By using the Delors Report as a starting point, the EU leaders adopted a three stage-approach for the transition towards the creation of the EMU, which was enshrined in the Treaty on European Union (TEU), signed at Maastricht in 1992[114]. This treaty is acknowledged as the most important step stressing a profound launch towards the European integration since the Treaty of Rome. Even if initially the draft contained the goal of building a federal union, this plan had to be abandoned due to the British strong opposition. As a consequence, it was preferred to opt for an «*an ever-closer union among the peoples and Member States of the European Community*» as it was already clarified in the Solemn Declaration of the European Union[115].

Besides committing member states to give up their national sovereignty over monetary power in favour of a supranational body, the European Central Bank, and the withdrawal of national currencies in favour of the Euro, the Maastricht Treaty should be celebrated for another important aspect. Indeed, not only did it give birth to the European citizenship - with the right to live and move in any member state - but it also strengthened the European cooperation in non-economic areas, such as immigration and asylum.

---

[112] Hesitations and different opinions how to continue the process were discussed. On the one hand, the French Finance Minister, Pierre Bérégovy, envisaged the creation of a common currency only for non-domestic market. On the contrary, François Mitterand and Jacques Delors conceived the single currency as the way for extending French influence over the Deutsche Mark. Yet, the fall of Berlin with the consequent re-unification of Germany accelerated the process over economic and monetary integration. The German Chancellor, Helmut Kohl, interpreted the single currency as the way to move to a highly integrated Europe. During the Strasbourg Council, held on the 8th-9th December 1989, European leaders decided to opt for an Intergovernmental Conference, that started on the 15th December 1990, with the aim of revising the Treaty.

[113] See point 23: «The adoption of a single currency, while not strictly necessary for the creation of a monetary union, might be seen for economic as well as psychological and political reasons as a natural and desirable further development of the monetary union. A single currency would clearly demonstrate the irreversibility of the move to monetary union, considerably facilitate the monetary management of the Community and avoid the transactions costs of converting currencies. A single currency, provided that its stability is ensured, would also have a much greater weight relative to other major currencies than any individual Community currency». Committee for the Study of Economic and Monetary Union, ''Report on Economic and Monetary Union in the European Community'', cit., p. 15.

[114] D. Hodson, ''Policy Making under Economic and Monetary Union: Crisis, Change and Continuity'' in *Policy-Making in the European Union*, edited by H. Wallace, M. Pollack, A. Young, Oxford, Oxford University Press, 2015, p. 170

[115] «The Heads of State or Government, on the basis of an awareness of a common destiny and the wish to affirm the European identity, confirm their commitment to progress towards an ever closer union among the peoples and Member States of the European Community». European Council, ''Solemn Declaration of the European Union'', *Bulletin of the European Communities*, VI (1983), p. 25.

Nonetheless, this treaty was signed with enormous and intricate complications. On the one hand, national referenda showed an initial contrasting attitude; on the other, United Kingdom harshly opposed the introduction of a single currency[116]. Following an agreement that allowed both Denmark and the United Kingdom to opt out from the single currency, the Euro, the Treaty was finally ratified by the member states[117]. This gave birth to the European Union, dismantling the former European Economic Community, creating an economic union at the price of a «*differential integration*» sanctioned by a single common currency, the Euro[118].

What is important about the Maastricht Treaty is the fact that it established binding dates and specific periods, providing a detailed timetable, in which steps toward the EMU had to be attained through a gradual convergence process:

- **Stage I (1990-1994).** This period had to be characterized by removal of capital controls, even if a derogation until the end of December 1995 was allowed in some cases.
- **Stage II (1994-1998).** This step was extremely important as the European Monetary Institute (EMI) was formed with the aim of strengthening cooperation between the central banks of the member states, ensuring stable prices and preparing the creation of the European Central Bank and the European System of Central Banks (ESCB). Even though recommendations were not binding, this stage was extremely important. Member states were required to give proof of their commitment to macroeconomic discipline by respecting the convergence criteria that would eventually lead to the adoption of the single monetary policy and single currency[119]. Still in this

[116] Problems in ratifying the Maastricht Treaty were creating a stressful situation that was compromising the expectations and the confidence that a Monetary Union would have been effectively introduced. Firstly, a referendum in Denmark rejected the Treaty in May 1992 and brought more instability on a system that was already fragile. This rejection was perceived as a real blow to the process of European integration that did not hinder neither stop the process of further cooperation though. Secondly, two curreny-speculations against the Italian lira and the British sterling further worsened the economic framework. Finally, further problems in the ratification emerged due to the *Eurosceptic* feeling in the United Kingdom and the outcome of the French Referendum, which brought a narrow majority in favour of the Treaty (only 51%). L. Cram, D. Dinan and N. Nurgent, *Developments in the European Union*, cit., p. 319.

[117] The European Union Law is always valid and applicable in all the member states. However, certain countries might negotiate for obtaining the ''opt-outs'' from legislation or treaties of the European Union. This is a mechanism for guaranteeing that when a given country does not intend to comply with a European Union Law policy in a certain field, it can ''simply'' opt-out avoiding a deadlock in the legislative procedures. Eur-Lex Access to the European Union Law, Opting-out, https://eur-lex.europa.eu/summary/glossary/opting_out.html, consulted on the 16th September 2018.

[118] *Differential integration* is used to explain the fact that not all Member states took part in the integration plan. Indeed, by signing the Maastricht Treaty, Member States decided to establish the so-called Maastricht Criteria or Convergence Criteria for building the economic and monetary union. Thus, to participate to this project, only those states respecting them, could take part. However, in addition to this aspect, opt-out clauses for those countries, e.g. Denmark and United Kingdom, that were respecting these criteria but simply did not want to participate to the monetary union, were launched. R. Schütze, *European Union Law*, cit., p. 23.

[119] The European Monetary Institute (EMI) was established in January 1994, based on the Maastricht Treaty. This body was settled as an intermediate for preparing the necessary and crucial steps for moving towards the European Central Bank (ECB). The EMI was thus entitled with its own legal personality and was concerned with the creation of the European System of Central Banks (ESCB), the European Central Bank and finally,

phase, the Broad Economic Policy Guidelines (BEPGs), a set of recommendation and guidelines on the economic policies, and the Stability and Growth Pact (SGP) were launched[120].

- **Stage III (1999 onwards).** The last and third phase was crucial. The irrevocable fixing of exchange rates and the institutional framework for the monetary and fiscal policy were involved. Moreover, the Eurosystem and the statute of the ECB would have been established in this context. A complex compromise had to be reached around this final and most important phase since the different member countries had very divergent and different positions[121].

The Maastricht Treaty made quite clear that the EMU had to be launched on the 1st January 1999, if no agreement had been reached before and if the conditions did not guarantee any further steps[122]. It was Germany that was pressing for ensuring that all the member countries respected and achieved sufficient convergence by respecting some important criteria under *the Maastricht Convergence Criteria.*

The Treaty resulted in a compromise given by economic convergence and clear dates to be respected[123]. The culmination into the Maastricht Treaty reflects once again the conflict of two opponent and competing views that had been present also at the time of the Werner Report where the economist view prevailed over the monetarist one. In addition to this, the Maastricht Treaty touched only exclusively issues concerning the economic and monetary union leaving apart any consideration for the political union[124]. In the meanwhile, also other projects affecting the political integration and sphere resulted in the Treaty of Amsterdam (1997), Nice (2001) and Lisbon (2009)[125].

---

the creation of the single currency. In its attempt to fulfill its tasks, the EMI aimed at coordinating monetary policy, strengthening financial stability, improving payment systems in the EU, developing a common monetary policy strategy and finally, preparing the single money market. Being involved in the transitional phase toward the ECB, the EMI organized preparatory and operational activities, between 1994 and 1998, to guarantee an effective monetary policy, supervision and harmonization of accounting rules and an efficient information system. European Central Bank, The European Monetary Institute (1994-98), https://www.ecb.europa.eu/ecb/access_to_documents/archives/emi/html/index.en.html, consulted on the 16th September 2018.

[120] In June 1997, on the basis of art. 121 TFEU (ex art. 99 TEC) and art. 126 TFEU (ex 104 TEC), the head of member states signed the Stability and Growth Pact (SGP), under the pressure of Germany, with the intention of strengthening the deficit procedure and the economic policy coordination. Similarly, the Broad Economic Policy Guidelines (BEPGS) was adopted to encourage flexibility in prices and wages. By intensifying the policy coordination, it was becoming quite evident that adjustments in the imperfect EMU were needed. D. Hodson, ''Policy Making under Economic and Monetary Union: Crisis, Change and Continuity'', cit., p. 171.

[121] France and Italy wanted to introduce a very specific and binding timetable to enhance the shift toward Stage III. On the contrary, both Germany and The Netherlands were convinced of the fact that the last and final stage could be advanced only when the conditions were favorable and when a sufficient degree of convergence, supposed to be nominal rather real, had been achieved. L. Cram, D. Dinan and N. Nurgent, *Developments in the European Union*, cit., p. 319.

[122] Art. 109j(4): «If by the end of 1997 the date for the beginning of the third stage has not been set, the third stage shall start on I January 1999. Before I July 1998, the Council, meeting in the composition of Heads of State or Government, […]confirm which Member States fulfil the necessary conditions for the adoption of a single currency». Treaty on European Union, Official Journal, C191 [1992].

[123] K. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe,* cit. p. 18.

[124] H. Tietmeyer, ''From the Werner Report to the Euro'', cit. p. 23.

The Maastricht Treaty should be celebrated for marking a break with the past and by overcoming the past wounds toward the direction of a further process of European integration and cohesion relying on new monetary order, awaited increasing growth, investment and employment[126].

1.3.2. The Convergence Criteria (or the Divergence Criteria?)

The «Maastricht Convergence Criteria» are criteria based on specific economic indicators, in terms of monetary, price and fiscal stability, that member countries have to respect and sufficiently fulfill whenever they want to enter the EMU. These criteria are based on the idea of leading to convergence among the countries. Yet, an attempt to meet them, being a requirement for joining the Eurozone, could bring to an opposite direction showing unpredictable and undesirable outcomes[127]. These criteria were and continue to be based on:

- **Stable Inflation rate,** which should be kept on a sustainable level and meant not to be higher than 1.5% of the three best performers[128]**;**
- **Stable exchange rates,** which should move within the *normal fluctuation band*. This means that member countries had to participate in ERM for two years without being exposed to severe fluctuations, devaluations and tensions to demonstrate a currency's ability to keep its exchange tied to monetary union's members**;**
- **Long-term nominal interest rates,** which should not exceed the average of the best three inflation performing states by more than 2% by for at least one year. This criterion is mainly related to the fact that long-term interest rates reflect also markets' assessment of long-term

---

[125] Among the big changes that occurred after the ratification of Treaty of Maastricht, the Lisbon Treaty is surely the most impactful. This Treaty was signed by all the 27 member states on the 13th December 2007 and entered into force only on the 1st December 2009 by amending the former Treaty of Maastricht, now known as the Treaty on European Union (TEU) and the former Treaty of Rome, now known as the Treaty on the Functioning of the European Union (TFEU). Besides improving the voting procedure (introducing the qualified majority voting), acknowledging a more prominent role to the European Parliament (for enhancing an increasing democracy and legitimacy), making legally binding the Charter of Fundamental Rights, it also recognised the legal personality of all the European institutions. Hence, the ECB gained the official status of European institution, whose president is now appointed by the European Council, while the Euro the status of official currency of the EU. Within this context, none of the *opt-out-clauses* were affected. In addition to, the Lisbon Treaty added one fundamental explicit right. EU members have now the chance of leaving European Union under art.50 TEU, which clarifies the procedures to be followed.

[126] D. Marsh, *The Battle for the New Global Currency*, New Haven and London, Yale University Press, 2009, p. 8.

[127] T. Paleta, ''Maastricht Criteria of... Divergence?'', *Review of economic perspectives,* II (2012), 12, pp. 92-93.

[128] The convergence criteria for inflation rate is supposed to be a necessary and fundamental condition for ensuring and establishing a successful monetary union being the ECB's monetary policy committed to ensuring price stability and sustainable inflation rate. Hence, if the rate is too high, common monetary policy under the ECB might be ineffective. *Ivi*, p. 94.

inflation. Hence, low long-term interest rates have a direct impact on financial markets by convincing them that inflation will be low[129]**;**

- **Government budget deficit,** which shall not exceed 3% of national GPD on the basis of the German ''*golden rule''*, according to which budget deficit is tolerable only if it corresponds to public investment spending[130]**;**
- **Public debt,** that should not exceed 60% of national GDP - chosen on the basis of the average of EU countries at the time of the Treaty's ratification - although slightly higher values are possible and permitted if they somehow move at a satisfactory rate towards the reference values;

The criteria were described as factors for demonstrating credibility and stability. In particular, national fiscal policies received the most attention and concerns on the assumption that they would have helped to protect the stability of Euro against an eventual inflation or pressure. On the contrary, the first three criteria were meant to guarantee monetary and exchange rate stability[131].

The main assumption was that countries would have faced an unsustainable situation for the national currency if the countries had entered the monetary union with a dissimilar inflation rate and fiscal condition. Yet, the restrictions on fiscal policy imposed by the Maastricht Criteria have been a source of controversies and debate to the extent that the criteria were generally considered harmful and useless[132].

No later than the 31st December 1996, the heads of governments, the EMI and the European Commission had to meet and report to ECOFIN Council whether member states were fulfilling the necessary conditions and the convergence criteria introduced for adopting the single currency.

Once both the European Parliament and ECOFIN Council made their assesment, it was confirmed whether it was appropriate and reasonable to proceed to Stage III and converge in the last irreversible step. Yet, prior to the end of 1998, a review of the progress in achieving the convergence criteria had to be repeated. By establishing such a mechanical system, many countries faced significant problems to the extent that very few countries were in the condition of respecting the criteria in 1997. As a

---

[129] R. Baldwin, *The economics of European integration,* cit., p. 491.

[130] Limits on budget deficits are imposed as it is thought that large deficits lead to a higher inflation. Indeed, as government borrows to finance its deficit, its debt increases. A similar process might put into question the ability of a government to repay back its debt which could be solved either by stopping lending to a government or by printing money that could raise inflation. Therefore, a threshold was applied under German pressure. The Golden Rule is recognized as a fundamental guideline for fiscal policy, according to which the government should borrow only for investing by dedicating 3% of national GDP and providing more benefits for the future generations. On the contrary, it should not borrow for financing the existing spending. Public investment is, indeed, considered a source of growth which creates resources to pay back the borrowing and debt. Furthermore, those countries that have applied this rule, have seen a reduction in their debt. Investopedia, Golden Rule, https://www.investopedia.com/terms/g/golden-rule.asp, consulted on the 16th September 2018.

[131] K. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe,* cit., p. 19.

[132] C. Wyplosz, ''EMU: Why and How it might happen'', cit., p. 12.

matter of fact, at the very beginning, it seemed that Stage III would have started on very exclusive basis, leaving apart several countries.

Among those who were having the most difficulties, Belgium and Italy were the countries encountering high levels of government debt accumulated over the years and exceeding the limit of 60% of the GDP. However, being anxious and enthusiastic about taking part into the third stage, they applied severe measures and reforms with the scope of tackling the fiscal problem[133]. Similarly, neither France nor Germany were respecting perfectly the government deficit[134].

The major problem in considering the system was the fact that these rules were treated initially as something immutable and fixed, due to harsh imposition of Germany[135]. The German government intended, indeed, to apply the criteria strictly for demonstrating the credibility and stability of the economic policies and the project itself. The situation was, however, further complicated by the United Kingdom that exercised from the very beginning an opt-out clause[136].

The final decision according to which countries would have or not entered the Stage III had to be taken on the 1st July 1998, by repeating the same assessment of 1996. Yet, in this occasion, the exclusive approach initially adopted was abandoned by including all the countries who wanted to be part of this project, starting from the 1st January 1999[137].

Since also France and Germany faced a big challenge in meeting the 3% deficit criterion, imposed by Germany itself, the concept of a strict interpretation and convergence was downsized through a softer

---

[133] Being eager and keen to be part of the first members of the EMU in 1999, the Italian government applied a series of reforms for decreasing inflation, from 5.4% in 1995 to 2% and the budget deficit from 7.1% to 3.3% of the GDP. This demonstrates the huge efforts in attempting to achieve the requirements for being part of the political process. Similarly, Belgium, whose debt amounted to 120% of GDP, subverted its public finances and started applying a strict budgetary discipline. Also Spain has made major efforts for being eligible for the EMU. On the one hand, they wanted to demonstrate their break with the past after the Francisco Franco's dictatorship and on the other, the country wanted to obtain further economic benefits. They aimed at obtaining a seat at the table to the extent that they could have influenced the evolution of the policies. M. Feldstein, ''The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability'', cit., pp. 29-30.

[134] Both France and Germany were forced to apply specific measures and maneuvers for meeting the criteria and decreasing the deficit. For example, in an attempt to reduce the budget deficit, the German government tried to re-valuate the gold stock to market prices – a maneuver which was however promptly stopped by the Bundesbank. *Ivi*, cit., p.39.

[135] L. Cram, D. Dinan and N. Nurgent, *Developments in the European Union*, cit., p. 321.

[136] Before the end of 1997, the UK had already obtained an opt-out clause on the basis that it would have not been involved in Stage III. By the time, politicians were convinced of the fact that the entry in the EMU would have been too destabilizing for the British economy and it would have caused a sort of economic suicide. *Ivi*, p. 322. Besides this, the reason why UK decided not to join the EMU, should be traced back to its very judicious stance toward the process of European integration. D. Marsh, *The Battle for the New Global Currency*, cit., p. 7.

[137] Belgium was one of the country that was facing enormous challenges in meeting the criteria. Yet, being not only a founding member of the European integration and the Common Market but also an enthusiastic supporter of monetary union, Belgium claimed that it could be kept out of the project. As a result, the debt criterion was interpreted more softly by means of «a debt moving in the direction of 60%». R. Baldwin, *The economics of European integration*, cit., p. 493.

interpretation[138]. By providing a more flexible interpretation of the criteria, eleven countries out of the fifteen members were thus allowed to join the last phase[139]. It is, thus, necessary to consider into details the criteria:

Inflation criterion. Among the criteria established in Maastricht, the easier to be achieved was the inflation convergence, which was supported by a rapid fiscal consolidation, though it had the collateral effect of creating a divergence in real interest rate between the *core countries* and the *periphery countries*[140].

The inflation criteria, however, raised some important problems and troubles. On the one hand, the exchange rate criterion interfered directly with the inflation one limiting the maneuvers for conducting a more adequate monetary policy. On the other, the inflation rate was calculated by considering a referential group, based upon an arithmetic average of the three best performers of the EU with very low inflation, creating in this way an unstable reference value. Furthermore, the inflation criterion was and is still based on a '*'principle of equal treatment''*. Basically, every single member country was evaluated in the same manner without considering the economic and structural changes that occurred for meeting the criteria. Moreover, inflation and reference values were considered upon nominal convergence rather than in real terms, which explains the inevitable divergence instead of convergence among countries[141].

Fiscal criteria. Government debt and deficit levels – the budgetary criteria - were the most challenging and difficult to achieve because of the policies adopted[142]. Moreover, highly criticized were the restrictions introduced concerning fiscal policy which were carried on the basis that restraint of fiscal policy is needed in order not to incur into a debt monetization as a consequence of an excessive budget deficit. Besides this, the reason for implementing fiscal criteria was at the very center

---

[138] By revisiting the concept of strict interpretation, the candidates for the EMU were given the chance to join the EMU, even if their budget was exceeding the threshold. The deficit had to be at a level closer to the reference value demonstrating that it had declined substantially and continuously. See Article 126(2)(a) of Treaty on European Union, Official Journal, C191 [1992].

[139] United Kingdom, Denmark and Sweden opted-out being disinterested in further measures. On the contrary, Greece, that was looking forward to being part of the project, was not given the chance to join because it was the least ready. Indeed, Greece was not able to reduce enough and sufficiently the interest rates for satisfying the requirements. L. Cram, D. Dinan and N. Nurgent, *Developments in the European Union*, cit., p. 322.

[140] The inflation criterion was one of the most important requirements since countries, that intended to join the Euro, should have proceeded towards a low inflation level or, at least, one that would have not exceeded the reference value. The main aim of this criterion was, however, to link the Southern European Countries, which suffered from high inflation levels, to countries with lower inflation levels, such as Germany. In the end, high-inflated-countries fulfilled this criterion as they conducted more restrictive economic monetary policies before joining the Euro thus constraining domestic demand while slowing down inflation. T. Paleta, ''Maastricht Criteria of.. Divergence?'', cit., pp. 94-95.

[141] *Ivi*, pp. 98-100.

[142] During the 1990s, several countries mirrored German tight monetary policy in an attempt to respect the convergence criteria and enter the EMU as it contributed to diminish inflation and promote convergence. Yet, it had a collateral effect: higher unemployment rate, slower growth, persistent deficits and tight fiscal policies. C. Wyplosz, EMU: Why and How it might happen, *Journal of Economic Perspectives*, cit., op. 11-12.

of a debate, especially because the Maastricht Treaty included an *escape clause*, allowing a country to join the Euro though it did not fully respect the reference values. This contributed from the very beginning to create divergence rather than convergence[143]. Like in the case of inflation, fiscal criteria were still based on referential values made upon an average for the EU countries and specifically, upon the *Golden rule*.

Most of the countries did not, in any case, satisfy these criteria exceeding the debt criterion as the Table 1.1. will show. Only in the case of Spain and the Netherlands could the *escape clause* be effectively applied, whilst with regards to both Italy and Belgium, they did not satisfy sufficiently the criterion[144]. Both countries had a national debt double than required and by joining the Euro, they contributed, from the very beginning, to the instability of the economic situation. With regards to the deficit criterion, only Greece exceeded enormously the reference value. Still, the *escape clause* was once again applied allowing also these countries that were not perfectly in line with the criteria to join the Euro.

Why countries that were not converging the criteria were given a pass, contributing in this way to instability, is for sure debatable. However, the answer can be found for sure in the political background and compromises made among countries willing to move towards a further integration. Politics won over economy and the respect of the criteria. Had been accepted only those countries who were satisfying effectively the criteria, then the whole project would have collapsed, once again[145].

Exchange rate criterion. This criterion was adopted without major controversy by means of the ERM II, designed as an asymmetric exchange rate mechanism that relied on wider fluctuation bands between the Euro and the national currency[146]. This criterion, which was introduced to ensure a

---

[143] An *escape clause* is a clause term or a provision in a treaty or a contract that allows a party to avoid performing specific conditions and satisfying certain requirements. In this case, this is represented by the current art. 126 TFEU, which allows a country to enter the Eurozone even though it does not fully satisfy the requirements provided that the budget deficit declines continually and that the value is close to the reference one.

[144] As it would have been discovered afterwards, some countries satisfied the criteria by cheating and providing fake data. Greece cheated on its book accounting. Similarly, Italy, Belgium and France lied on their real deficits by proposing fictitious book-keeping. Finally, even Germany, which had always been considered a fiscally honest country, was suspected of having misled procedures by over-evaluating golden and foreign exchanges reserves. T. Paleta, ‘’Maastricht Criteria of.. Divergence?’’, cit. pp. 92-93

[145] T. Paleta, ‘’Maastricht Criteria of.. Divergence?’’, pp. 105-108.

[146] ERM II was introduced, in 1997, through the Amsterdam Treaty and entered into force on the 1st January 1999 being the successor of the ERM. Hence, it was created with the aim of ensuring and containing rate fluctuations between the Euro and the other currencies. The mechanism had been created with the scope of preserving the economic stability of the single market and helping the countries to join the Euro-area. Considering the convergence criteria and the requirements, the exchange rate stability is a condition required that should be respected. Moreover, even if the participation to ERM II occurs on a voluntary basis, a country must participate in the mechanism for at least two years without being exposed to devaluations or tensions in order to join the Euro. Indeed, fluctuations are allowed only within certain limits, set up to 15% or below the rate. When needed, the currency can be supported through interventions with the aim of preserving the exchange rate. ERM II is not only a tool for confirming the sustainability of economic convergence but also an indicator of the appropriate conversion rate to be followed when member states qualify. European

smooth functioning of the Common Market and above all, of the Euro's stability, was extended to countries with the opt-out clause in an attempt to avoid competitive devaluations. Hence, a two-years-membership was demanded to verify and analyze parity, convergence and consistency between the economic policies.

Despite that, still this criterion was violated like the others, revealing the political dynamics underpinning the project, rather than the real economic merits. Countries such as Italy, Austria and Finland participated for a shorter time than requested.

One of the major problems of the criterion concerned the interpretation and definition of ''*normal fluctuation band''* and ''*without dramatic tensions''*. Indeed, the lack of a precise definition of what was intended neglected an effective and exhaustive interpretation allowing countries to join, even though they were exposed to severe fluctuations[147].

Interest rate criterion. Like the exchange rate, which relies on the credibility of the government, also the fulfillment of this criterion strictly depended on the confidence and trust of the financial markets. As a matter of fact, this criterion was considered a predictor of confidence in the fiscal position and an indicator of inflation convergence between European countries. This belief was put into serious question by the crisis of the ERM in the 1992-1993, demonstrating that interest rates cannot be considered a reliable factor for convergence but rather, a source of divergence.

By proceeding in this way, the seriousness and the credibility of the criteria, whose values for the single countries are reported in Table 1.1, were put into question, especially for the real efforts done by governments to converge with them[148].

Having established which countries could be part of the system, the final transition toward the adoption of a single European currency, the Euro, had to be gradual, where the exchange rates had to be fixed and to be kept throughout the whole transition. The Euro was launched officially on the 1st January 1999. Yet, notes and coins would have appeared only and exclusively starting from the 1st January 2002 and would gradually substitute national currencies[149].

What should have been understood by the time was that being a member of the EMU would have not automatically meant gaining an influential and powerful voice in the European policies. On the contrary, it would have implied a limitation of national powers, a transfer of monetary sovereignty and

---

Commission, ERM II – the EU's Exchange Rate System, https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/introducing-euro/adoption-fixed-euro-conversion-rate/erm-ii-eus-exchange-rate-mechanism_en , consulted on the 16th September 2018.

147 T. Paleta, ''Maastricht Criteria of.. Divergence?'', cit. pp. 108-111.

148 J. Mccornick, *Understanding the European Union*, cit., p. 95.

149 Euro coins began to circulate only starting from the 1st January 2002 substituting gradually national currencies. Yet, the single currency was launched ''virtually'' starting from the 1st January 1999 circulating in a non-physical form, such as among banks, cheques and electronic transfers, in conjunction with the locking of exchange rates and the issuing of new government bonds and debt in Euros. On the contrary, notes and coins continued to be used as *legal tender* until the effective launch of the new currency, which was introduced gradually in the market.

lastly, the acceptance of rules. Some countries embarked in this ambitious project being fearful of being discriminated and isolated had they not taken part[150].

By considering the criteria, the Maastricht Treaty had produced a system which has underestimated fiscal policies during the transition and in the monetary union itself. Indeed, a lack of attention and of concern was given to the stabilisation issues and coordination mechanisms.

The Convergence Criteria, indeed, put in place monetary and fiscal criteria that were too rigid to be respected by some countries. Similarly, national structural factors and economic conditions were simply not taken into account. As a result, membership criteria created a too restrictive and mechanical system underrating a more appropriate selection procedure[151].

The criteria had been introduced without a clear intention of respecting them for the simple fact that the monetary union was mainly driven by political considerations. The desire of an European internationalism, national self-interests in locking the macroeconomic policies at a EU level and the idea of preventing another war by creating more cohesion prevailed over selecting ''joining-members'' upon real economic merits[152].

The Maastricht Criteria were an integral step through which member countries that intended to join the Euro had to pass through. Yet, rather than bringing convergence among the countries, these criteria created a situation of divergence and brought additional costs due to the decision of choosing criteria based on nominal rates rather than real. Hence, the Eurozone is characterized by economies with very different levels and speeds, confirming the fact the European countries would have struggled in forming an Optimum Currency Area (OCA), due to the several asymmetric shocks and a lack of certain flexibility. Joining the EMU in a similar situation could be only harmful and damaging for the competitiveness of a national economy[153].

The EMU, as it has been established in Europe, did not constitute a natural path but rather emerged as a forced project, which relied on the existence of an *escape clause* and on the disrespect of the same

---

150 M. Feldstein, ''The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability'', cit., p. 30. By considering the Danish case, when they voted through the referendum on the 2nd August 1992 against the ratification of the Maastricht Treaty, they were threatened to lose trade benefits deriving from the single market. As a consequence, having witnessed a similar situation, most of the leaders and politicians tried to raise some pressure over their national citizens to support the Euro-project. Yet, also in France, the polls showed an extremely low consensus at the referendum held on the 20th September 1992 for the ratification of the Maastricht Treaty (51% in favour). In the end, Denmark held a second referendum on 18th May 1993 which was approved by 56.7%.

151 K. Gaynor, E. Karakitos, *Economic Convergence in a Multispeed Europe*, cit. p. 22.

152 The German Chancellor Helmut Kohl, one of the most influential supporters of the monetary union, was convinced of the fact that by creating such union and cohesion, Germany would have obtained more reliability and trust by the other countries. Furthermore, being bound with the others European countries through common policies and a common currency, the countries would have been less prone to start a new conflict. EMU became the ''magical'' tool through which peace on the European territory could be consolidated. M. Feldstein, ''The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability'', cit., pp. 25-26.

153 D. Hodson, ''Policy Making under Economic and Monetary Union: Crisis, Change and Continuity'', cit., p. 171.

criteria for inclusion, showing unavoidable collateral effects and consequences. ‘*’Joining-countries*’’ tried, indeed, to depress domestic demand to meet the Maastricht conditions for EMU membership while ignoring other important factors, as they saw the EMU as an initial step toward a federalist European political union. Specific political decisions were made with the only intent of joining the Eurozone, without an appropriate economic-fiscal structure, thus contributing to create a situation of instability and uncertainty.

To confirm the strong cohesion among countries, membership in the EMU and the adoption of a single currency were supposed to be permanent to the extent that neither provision nor allusion for leaving the EMU is evident in the Treaties. Membership is, thus, *an irreversible step* unless there is a serious economic disruption or downfall of the peaceful coordination among the member states[154].

[154] M. Feldstein, ‘’The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability’’, cit., pp.36-42.

Table 1.1. The European countries and the Convergence Criteria[155]

Country	Budget Deficit (3%)	Public Debt (60%)	Inflation rate (1.5%)	Interest rate (%)
Austria	3.0	63.1	0.9	5.6
Belgium	2.8	123.2	0.9	5.7
Denmark	1.2	64.3	2.3	6.2
Finland	2.0	52.2	1.6	5.9
France	3.2	61.1	1.1	5.5
Germany	3.2	58.7	1.3	5.6
Greece	5.2	99.5	4.5	9.8
Ireland	1.2	61.7	0.3	6.2
Italy	3.2	113.8	1.7	6.7
Luxembourg	2.8.	8.5	1.5	5.6
Netherlands	2.3	65.6	2.2	5.5
Portugal	2.9	55.2	2.1	6.2
Spain	3.0	66.2	1.9	6.3
Sweden	2.1	68	2.6	6.5
United Kingdom	2.8	43.4	1.7	7

Source: IMF World Economic Outlook 2018

[155] The table has been created by taking data from the IMF DataMapper and using the World Economic Outlook with the scope of showing the values of the European countries that were applied for joining the Euroarea. The data have been collected focusing exclusively on 1997 and the criteria requested by the Maastricht Treaty for providing the reader with a brief and comprehensive summary of the actual situation by the time. IMF DataMapper – World Economic Outlook, https://www.imf.org/external/datamapper/datasets/WEO, updated in April 2018, consulted on the 22th September 2018.

1.3.3. Big steps, big changes, great consequences

The EMU has been achieved as a result of the strong axis around the Franco-German alliances, emphasizing the unique aspect of this collaboration, and especially as a way to counterbalance Germany reappearance on the scenario after its reunification. France and Germany have both influenced the creation in terms of their perceptions and self-interests, which have been more or less willingly accepted by the other members states[156]. If, on the one hand, France has sought to gain an influential role in the European policies by creating the EMU in order not to be dominated by Germany, the latter has tried to influence the procedures by dominating the monetary policy imposing the '*stability pact'*, introducing fiscal discipline and becoming the main leader[157].

However, this project subverted completely the national monetary policies, forcing member states to abandon their monetary sovereignty and independence in favour of a supranational monetary policy to be decided by an independent European Central Bank (ECB), with its own legal personality, entitled with formulating opinions, recommendations, establishing a monetary policy mainly focused on price stability[158].

By giving up their national monetary policy, member states have completely changed their policies in an attempt to respect the criteria and the terms settled down within the EMU, taking part to an historic step never seen before. They have abandoned and then transferred - in an irrevocable way at the European level - part of their sovereignty and specifically the macroeconomic policy-making[159]. Nonetheless, both the Euro and the European Central Bank have gained worldwide recognition and acknowledgement[160].

The introduction of the monetary union and the single currency could be seen as the most far-reaching event in the world history in the twentieth century, where decisions to proceed in this way reflected

---

[156] During the significant years of the *Delors Report* and the negotiation for the Maastricht Treaty, Germany has been able to defend promptly its interests succeeding in imposing its conditions for the monetary union. Germany has kept the D-Mark during the reunification and it has used this specific moment of history for giving a further impetus to the monetary union. However, Germany is not the only country that played a crucial role. Indeed, also France had been very influential in the European integration. Since UK has always opposed the economic project, the D-Mark became an anchor currency at the time of the EMS allowing the transition toward the single currency. Finally, having three wars between France and Germany dominated the European scenario for many years, cooperation between these two former rivalries allowed the great historic shift. D. Marsh, *The Battle for the New Global Currency,* cit., p.11.

[157] M. Feldstein, ''The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability'', cit., pp. 28-29.

[158] D. Hodson, ''Policy Making under Economic and Monetary Union: Crisis, Change and Continuity'', cit., pp. 184-185.

[159] The trilemma of a monetary union or the '*'impossible trinity''* is an economic theory that clearly explains the functioning of an open economy. A country can, indeed, ''manipulate'' only two of three elements among monetary independence, fixed exchange rates and free movements of capital. Yet, this theory becomes quite obsolete when countries join a monetary union as exchange rates are removed and as well as capital controls – it being one of the four key freedoms of a common market. H. Beck, A, Prinz, ''The Trilemma of a monetary union: Another impossible trinity'', *Intereconomics,* XLVII, I (2012), pp. 39-40.

[160] H. Tietmeyer, ''From the Werner Report to the Euro'', cit. p.25.

political views concerning the future of Europe, benefits and disadvantages to the single countries and policy-makers[161].

Despite some important achievements, the situation has had major implications economically and socially, ranging from higher taxes to cuts on the welfare spending. Yet, it has also become quite evident that some countries, such as Germany, have obtained more benefits through more favourable financing options and conditions than other member states that have lost some privileges they once had. This highlighted some weaknesses and structural problems, which without a proper correction could convey into further tensions and increasing imbalances[162]. On the one hand, some countries might be hindered in enhancing their growth while others with serious structural problems might incur into an excessively restrictive monetary policy[163].

The creation of the EMU has completely altered the political forces by redistributing powers both at national and European levels. Yet, the European Monetary Union has seen the gradual imposition of a sole and single will: the German one. On the one hand, it has extended its monetary policy on the other European member countries; on the other hand, it has been responsible for the introduction of the '*excessive deficit procedure'*. This was introduced in June 1997 and was initially rejected by a large majority of countries being considered as extremely restrictive.

Moreover, even the creation of this convergence process as well as the criteria have been the result of an imposition of the German willingness with the aim of creating a currency as strong as the Deutschemark was at the time of the European Monetary System (EMS)[164]. However, this pressure has been even extended to the location of the ECB, whose statute and objectives reflect, by pure coincidence, those of the Bundesbank[165]. The Germans were, indeed, convinced of the fact that an ECB modelled on the Bundesbank would have discouraged inflation and promoted both political and social progress. In this way, Germany has been able to assure a controlling position in European politics and to impose a German-style monetary system for the EMU during the long path towards the EMU, which has been accepted in the EMU countries[166].

Furthermore, the EMU has not only changed the national policies but it has affected directly also the relationship with global markets, economically and financially. It has thus created a system which has

---

[161] M. Feldstein, ''The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability'', cit., p. 23.

[162] Germany is at the very center of the controversies that can be seen within Euro-area. Indeed, it has enjoyed huge benefits by strongly supporting its export-oriented economy, increasing its competitiveness in contrast to the other European countries and by increasing its export surplus while avoiding an encouraging domestic demand that would have helped the other EMU states. D. Marsh, *The Battle for the New Global Currency,* cit., p.3.

[163] H. Tietmeyer, ''From the Werner Report to the Euro'', cit., p. 28.

[164] C. Wyplosz, ''EMU: Why and How it might happen'', cit. p. 7.

[165] The Bundesbank has always been concerned with favoring price stability and strong independence of the central bank from the government, by avoiding the involvement in bank supervision and finally, denying the function of lender-of-last-resort.

[166] D. Marsh, *The Battle for the New Global Currency,* cit., p.10.

given a prominent role to central independent bankers and price stability, being the primary aim of the ECB, that has somehow confirmed real interests of the union itself, leaving apart some other important issues, such as democratic legitimacy.

In addition to, what has emerged is the fact that all the leaders have somehow acted to meet the criteria imposed by the system for favouring a greater integration process, by applying a series of economic reforms in countries, such as Portugal, Italy and Greece, driven by the desire of qualifying for the monetary union[167]. Surely, the EMU has completely reconfigured monetary power within the European Union and has raised some critical concerns by making even more evident that EMU member states are committed to maintain and respect adequate flexibility and competitiveness besides an appropriate competition-oriented policy[168].

EMU has, thus, completed the process of *Europeanization*, bringing European integration into a new era which has given birth from the very beginning to a ‘’multi-speed’’ Europe. Some countries, such as Denmark and United Kingdom, have been given the opportunity to opt-out from the single currency while others, once their application was approved, had to join and take part to the third and last stage.

Being the structure of the economic and monetary union somehow incomplete, this ambitious project needs further measures to be improved and completed by introducing a more cohesive and more collaborative link among the member states that could strengthen the plan already started since, ever before, sovereign states have abandoned their independence to introduce one single currency[169].

Europe and, in particular, the EMU, should now create the conditions for overcoming both external threats and internal divisions.

The union has been a political project mainly driven by economic factors, external forces and international strains to create a solid and credible European monetary system. Yet, being the EMU not based upon economic merits, it cannot stop at the monetary level but should proceed with the clear aim of improving the current policies orientation.

The Euro, exalted as the greatest success of the end of the Twentieth century, has brought many benefits by breaking down barriers among different countries and people. Not only did it transfrom Europe into one of the leading global markets by including some of the most important world economies, such as Germany, France and Italy, but it has also created a powerful bank, the ECB - second only to the FED’s authority. Lastly, it even contributed to the establishment of a tri-currency

---

[167] *Ivi*, p.9.

[168] H. Tietmeyer, ‘’From the Werner Report to the Euro’’, cit. pp. 28-29.

[169] Adopting a single currency implies a series of question of doubts, economic effects and consequences that should be considered when creating a monetary union. On the one hand, a common currency can remove barriers, eliminate transaction costs and enhance currency credibility preventing speculations and encouraging business. On the other, a single currency can interfere with the development of the single market by increasing the wealth-gap across countries. Binding countries with different economic cycles and depriving them of their national monetary policy, through which a state can devaluate and adjust interest rates, can be very risky and can have significant consequences. J. McCornick, *Understanding the European Union*, cit., pp. 197-200.

system, dominated by the US dollar, the Euro and the Japanese Yen. Yet, the EMU is also criticized for its shortcomings and for being an imperfect project introduced upon political reasons and incapable of bringing the economic convergence promised due to the structural diversity among the states[170].

By adopting a single currency, indeed, the European countries with different economies and internal conditions, are unable to control, through interest rates and exchange rates, the economic shocks to which they might be exposed, increasing in this way cyclical instability and structural unemployment[171].

A strong common currency to continue to be powerful does not only need a competitive and flexible economy but also political strength as well as clear rules for long-term adjustments. If not, the gap among the *core* and the *periphery* countries will widen resulting in a mere growing fragmentation. Many politicians have, indeed, relied too much on the idea that a supranational institution as the ECB can produce better decisions than any other states, giving up, in this way, part of their responsibility. However, as Pierre Werner was convinced of, the Monetary union is the first step in the direction of a greater political integration[172]. The monetary union seems to be the prelude to further measures to be adopted and coordination in other fields, such as the non-economic and non-monetary related policies[173]. Nonetheless, before taking further steps, studying the weaknesses and shortcomings of this imperfect system is necessary[174].

---

[170] D. Marsh, *The Battle for the New Global Currency,* cit., pp. 1-3.

[171] Being part of a monetary union implies having the same interest rates and (inflexible) exchange rates as the other countries. This means that interest rate and currency value can be adjusted only exclusively if other countries of the EMU suffer from the same decline in demand. *Ivi*, p.34.

[172] «La réalisation progressive de l'union monétaire est un processus à portée politique particulièrement significative. L'union économique et monétaire signifie que les principales décisions de politique économique seront prises au niveau communautaire et donc que les pouvoirs nécessaires seront transférés du plan national au plan de la Communauté. Ces transferts de responsabilité et la création des institutions communautaires correspondantes représentent un processus de signification politique fondamentale qui entraîne le développement progressif de la coopération politique. L'union économique et monétaire apparaît ainsi comme un ferment pour le développement de l'union politique dont elle ne pourra a la longue se passer». CVCE, Exposé de Pierre Werner sur l'Union économique et monétaire en tant qu'étape vers l'Europe politique (Davos, 28 janvier 1972), https://www.cvce.eu/en/obj/address_given_by_pierre_werner_on_economic_and_monetary_union_as_a_step_towards_a_political_europe_davos_28_january_1972-en-b0377149-9870-48ea-bca3-f1793ec80f87.html, consulted on the 16th September 2018.

[173] M. Feldstein, ''The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability'', cit., p.27.

[174] D. Marsh, *The Battle for the New Global Currency,* cit., p. 10.

CHAPTER II

THE EUROZONE EXPERIENCE:
AN ANALYSIS OF WEAKNESSES AND FRAGILITIES

PART ONE
Economic Monetary Union:
A source of drifting asymmetric divergence

2.1. Eurozone: The creation of an imperfect system

The creation of the European Union is considered as one of the most significant and distinctive political events that occurred in the course of the twentieth century. By showing an incredible and unprecedented willingness to cooperate and preserve peace, European countries joined into one supranational entity.

European integration has been driven by several considerations, ranging from the need of creating «*a closer union*» to the attempt of protecting national interests. The final step, culminated in the Economic and Monetary Union (EMU), is the result of a complex economic and political construction based on the assumption that European unity could have been obtained through economic integration[175].

The creation of the Eurozone subverted completely the international system. Firstly, it transformed the EMU into one of the leading global traders. Secondly, it has formed one of the most influential economic regions in the world. Lastly, European member states have been exposed to a series of changes in terms of new economic structures and market dimensions. Surely, this significant shift has

[175] As already explained in Chapter I, the EMU envisaged by Jacques Delors, the President of the European Commission in 1989, conceived this ambitious plan as a step for enhancing and completing the single market. On the contrary, the French President, François Mitterand, thought that by creating a monetary union, German influence exerted by the Bundesbank in the European Monetary System (EMS) would have been contained. Finally, the German Chancellor, Helmut Kohl, perceived the EMU as the way for binding new-reunified Germany to the other European countries, improving trading situation and avoiding possible competitive devaluations. P. Hall, ‘’The Euro crisis and the future of the European Integration’’ in D. Acemoglu (edited by), *The Search of Europe: Contrasting approaches*, Madrid, BBVA, 2016, pp. 50-51.

contributed to give more economic and political weight to the single individual European countries by forming a cohesive block rather than remaining fragmented[176].

The European Monetary Union was expected to enhance greater macroeconomic stability, prosperity and economic convergence. Most of the countries were convinced that by sacrificing monetary sovereignty in the short-term, they would have obtained greater and positive gains in the long-term. On the one hand, the common currency was introduced on the assumption that it would have boosted economic integration. On the other hand, trade and capital mobility as well as coordination of fiscal policies were believed to bring prosperity among the European countries preventing any further exposures to international turbulences[177].

Each country had enough motivations and reasons for forming a monetary union. Nonetheless, economists and scholars had strongly warned that Europe is characterized by different economic and structural developments making already evident that the Eurozone was not an optimum currency area[178]. Yet, European countries proceeded not considering this crucial aspect. Hence, starting from the 1st January 2002, they gave up their national currency and adopted a common single one: the Euro[179].

By creating the *Euroarea* or *Eurozone*, European countries gave up their own monetary independence in favour of one single supranational and independent institution, the European Central Bank (ECB). The whole framework was built on two considerations. Firstly, commercial and political links among European member-states would have deepened and improved. Secondly, the Euro would have ensured greater exchange-rate stability on the international monetary system[180]. Nonetheless, the reality would have been different.

The architecture of the EMU and, specifically, the Eurozone, emerged as something imperfect and incomplete.

---

[176] R. Zeppernick, ''Effects of the Euro on Trade, Capital Markets and the International Monetary System'', *Intereconomics*, XXXIII, VI (1999), p. 279.

[177] Eurozone was created for sheltering European countries from further international instabilities and turbulences in the financial markets. In addition to, IMF believed that by adopting a common single currency, all the Eurozone members would have been protected from any asymmetric shock on the assumption that both monetary and fiscal policy had been checked before joining. R. Zeppernick, ''Effects of the Euro on Trade, Capital Markets and the International Monetary System'', cit., pp. 279-280.

[178] *Ivi*, p. 50.

[179] In 1999, eleven countries joined the Eurozone. These were, initially, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal and Spain. Starting from 2001, the Eurozone was expanded to Greece, followed by Slovenia in 2007. In 2008, both Malta and Cyprus joined the Euro, followed by Slovakia in 2009, Estonia in 2011, Latvia in 2014 and finally, Lithuania in 2015. E. Martinez-Garcia, V. Grossman, ''Consequences of the Euro: Monetary Union, Economic Disunion?'', *Economic Letter – Dallas Fed*, XXII, II (2016), p. 1.

[180] Already by 1999, economists were convinced that the Euro would have become one of the major stable global currencies, being focused on exchange-rate and price stability. Nonetheless, by the time, it was also recognized that it was vital for the Euro and specifically, for the ECB to pursue an efficient and effective stability-oriented policy so as to guarantee the attractiveness of the new currency and ensure successful economic and fiscal policies for the Eurozone countries. R. Zeppernick, ''Effects of the Euro on Trade, Capital Markets and the International Monetary System'', cit., pp. 284-285.

Firstly, the ECB was built on minimal functions: (1) an excessive focus on price stability; (2) prohibition on purchasing sovereign debt and (3) banking supervision left at national level. From the beginning, the ECB would have been a ‘’crippled’’ bank being deprived of the most important tools of central banks.

Secondly, countries with very different economic situation and structural factors joined the *Eurozone*. Lastly, fiscal policies had received unreasonably less attention than the traditional criteria for forming an optimum currency area[181]. Inevitably, a similar approach would have manifested its consequences through economic and asymmetric shocks and increasing divergence[182].

Homogeneity or at least, similar economic structures are fundamental conditions for ensuring a smooth and well-functioning monetary union. Furthermore, by breaching the Maastricht Convergence Criteria and opting for a too generous interpretation - deficit exceeding the limit of 3% of GDP and debt ration over 60% - terrible outcomes would have come to light[183].

Being Eurozone countries heterogeneous from a structural, economic and fiscal point of view, a common monetary policy based on the principle of «*one-size-fits-all*» exacerbated the split within the currency area in terms of recession in some countries and expansion in other.

Surely, a monetary union can bring enormous benefits, ranging from lowering transaction costs to increasing transparency and trade while offering better opportunities, whenever the criteria of the optimum currency area (OCA) are respected. However, this is not the case of the *Eurozone*[184].

By binding countries with very different levels of political developments and economies, the *Euro-area* is hit by asymmetries, economic shocks and internal fragmentation which is also marked by the rise of the «*better coordinated market economies*», such as Germany, Belgium, Austria, Finland and the Netherlands and the «*Mediterranean countries*», such as Italy, Spain, Portugal and Greece[185].

---

[181] J. Frankel, ‘’Causes of Eurozone crisis’’, in R. Baldwin, F. Giavazzi (edited by), *The Eurozone Crisis: A consensus view of the causes and a Few Possible remedies*, London, CEPR Press, 2015, pp. 110-111.

[182] A shock is considered asymmetric when only one part of the currency union is badly affected by an event while the other continues to enjoy benefits. Two parties diverge in terms of productivity, economic stability and employment rate. Moreover, if countries experience a positive or eventually a negative demand shock, the result expected would be a disequilibrium within the currency area as prices in certain countries would be too high or too low, depending on the forecast scenario. J. Jager, K. Hafner, ‘’The Optimum Currency Area Theory and the EMU’’, *Intereconomics*, XLVIII, V (2013), pp. 315-316.

[183] C. Noble, *Examining Eurozone Divergence*, bachelor thesis, University of Puget Sound - Economics Department of Economics Theses, Year 2011-2012, sup. K. Stirling, pp. 2-3.

[184] A monetary union can reap enormous benefits ranging from risk-sharing mechanism, capital market integration to fiscal transfers. Yet, the more weaken the risk-sharing mechanism is, the lesser benefits will be gained through the common currency policy. E. Martinez-Garcia, V. Grossman, ‘’Consequences of the Euro: Monetary Union, Economic Disunion?’’, cit., p. 2.

[185] The *well-coordinated countries* are characterized by well-developed and structured trade unions and associations, being in the position to bargain and promote exports. By focusing on high-quality and high-specialised production, these economies are able to get the main benefits and advantages for promoting an export-led and vocational training economy. On the contrary, the *Mediterranean economies* are organized differently, with competing unions, weak employers’ associations, occasional social pacts and difficult wage coordination. Lacking coordinated skill formation, most of the enterprises in these economies rely on low-cost labour rather than high-value added production and innovation. P. Hall, ‘’The Euro crisis and the future

Membership should have not been expanded so quickly and easily as the Euro affects countries differently. *Northern countries* pursue export-led growth economies at the expenses of domestic consumption while *Southern countries* focus on expanding domestic demand at the expenses of increasing both price and wage inflation. Hence, their economies have lost both vitality and vigor[186].
EMU and Eurozone are, thus, composed of permanent and indelible differences in the organization of the European economies and institutions that require different adjustment mechanisms. Far from being an optimum currency area (OCA), diverging business cycles are present, labour mobility is extremely limited and wage as well as price rigidity affect the whole system[187].

2.1.1. The Optimum Currency Area (OCA) Theory and the incompatibility with Eurozone

The launch of the Euro has caused a significant shock to European economies affecting some member countries more than others. European economic integration has relied on two different approaches: (1) A common single currency would have stimulated and expanded labour and capital mobility, integrating more European economies, according to the Optimum Currency Area (OCA) Theory and (2) EMU would have exacerbated the differences among the Euro member-states according to the Heterogeneity Hypothesis[188].
The introduction of the Euro should have been postponed until when countries were in a condition of meeting the OCA criteria, even though without doubt, the Euro stands now as one of the greatest political achievements.
Nonetheless, by adopting one single currency for different countries, one monetary policy is automatically introduced, which is considered appropriate only and exclusively when countries constitute an «*Optimum Currency Area*»[189]. This theory is extremely important when a smoothly functioning of a monetary union, relying on convergence, labour mobility and fiscal integration, is wished[190]. In order to meet this situation, four specific conditions, which can be grouped into two

---

of the European Integration'', cit., pp. 52-53.

186 *Ivi*, pp. 52-54.

187 In the Eurozone, wage policies and price developments are still kept at a national level due to a series of institutional arrangements, such as wage-setting and nationally regulated prices. Yet, since adequate adjustment mechanisms for stabilizing the monetary union are absent, wider divergences than expected are reinforced. C. Wyplosz, ''The six flaws of the Eurozone, *Economic Policy*, XXXI, LXXXVII (2016), p. 563.

188 According to the *Heterogeneity Theory*, both volatility and the main differences tend to resist and persist even more in the less-integrated monetary unions despite a long economic integration. By putting together different economies, the result can be a «*heterogeneizing effect*» driven by the fact that a greater specialization can emerge due to a higher inter-trade. If this effect predominates, then the monetary union will be extremely unstable and the economies less correlated. G. Karras, ''How homogenizing are monetary unions? Evidence from the U.S. states'', *North American Journal of Economics and Finance*, XIV, III (2003), pp. 381-383.

189 J. Sheridan, ''The consequences of the Euro'', *Challenge*, XLII, I (1994), pp. 43-44.

190 The Optimum Currency Area Theory, funded by R. Mundell and further developed by R. McKinnon and P. Kenen, analyzes conditions and circumstances in which a country might suffer or benefit from joining to a currency union. By giving up a national independent monetary policy, its loss should be compensated by monetary efficiency gains that relies on a major competitiveness due to price decline, stimulation of exports

different groups, should be met: (1) criteria that reduce the chance of being exposed to asymmetric shocks, such as similarity of economies, trade openness and a low degree of specialization; (2) criteria that could improve adjustments to asymmetric shocks, such as homogeneity of preferences, labour mobility, well-integrated factor markets and transfer payments[191]. More specifically:

Similar economic structure. Countries that join a monetary union should possess similar or, at least, compatible economic conditions and structures, which would allow them to produce analogous products and services and share economic diversification. In this way, members should be somehow affected by the same business cycles (recession or expansion). On the contrary, when structurally different, two countries have higher probabilities of being affected and attacked by economic shocks in a dissimilar way[192].

Similarity is a fundamental element in a monetary union as it helps enhance convergence by reducing asymmetric shocks and adopting one efficient single monetary policy. Yet, in case of misalignment with this condition, member countries will find themselves in such a position to adopt different policies to satisfy national economic needs. In such situation, one monetary policy would be absolutely inappropriate and rather detrimental, affecting countries differently[193].

Openness and intraregional trade. This is a very important condition to respect as it signals the degree of trade participation and openness. This OCA criterion, indeed, depends on openness as the advantages of fixed exchange rates augment with the degree of economic integration[194]. The completion of the single market must be guaranteed so that goods, services and capital can move freely, without borders nor restrictions, responding to price signals.

Homogeneity of preferences. This is considered an essential element, especially for responding and managing efficiently economic crisis. Consensus must be reached over monetary policy so as to deal with asymmetric shocks that could emerge. If this is not the case, conflicts among countries can emerge weakening also support for the currency area[195].

If these conditions are fulfilled, the monetary union will emerge as an Optimum Currency Area (OCA). In similar situations, giving up national monetary policy is not a loss but rather a victory for

---

and aggregate demand. J. Jager, K. Hafner, ‘’The Optimum Currency Area Theory and the EMU’’, cit., p. 315.

[191] *Ivi*, cit., p. 316.

[192] J. Sheridan, ‘’The consequences of the Euro’’, cit., pp. 44-45.

[193] B. Eichengreen, ‘’The Eurozone crisis: the theory of optimum currency areas bites back’’, *Notestein Academy White Paper Series*, III, (2014), p. 3.

[194] As the macroeconomist J. Frankel highlights, fixing exchange rates has mainly two advantages: (1) it reduces transaction costs that can undermine and discourage both trade and investment and (2) it provides a *credible nominal anchor* for monetary policy. Hence, exchange rates gain credibility and reduce inflationary expectations. Yet, under a fixed-exchange rate system, variability in output is low while openness acts as an automatic stabilizer. Therefore, openness, especially in terms of labour movement, is a crucial element in an OCA. If an economy is well-integrated with the other member states, workers will move from one country to another, in case of economic shock and recession. J. Frankel, ‘’No Single Currency Regime is Right for All Countries or At All Times’’, *NBER Working Paper*, VIICCCXXXIX, (1999), pp. 15-16.

[195] J. Jager, K. Hafner, ‘’The Optimum Currency Area Theory and the EMU’’, cit., p. 316.

gaining power and recognition worldwide, while responding symmetrically with identical monetary policy adjustments[196].

In addition to, the Optimum Currency Area Theory envisaged a series of adjustment mechanisms for responding to asymmetric shocks, that are:

Price and wage flexibility. Complicated economic situations can be overcome whenever wages and prices are free to adjust. In case of recession, unemployment will tend to increase, which would request declining wages through internal devaluations. For example, the Eurozone is affected by an extreme and inflexible rigidity that foster an increasing unemployment[197].

Capital and labour mobility[198]. These two elements together enhance competitiveness and improve national economic conditions, if workers are willing to move from countries affected by economic decline to other affected by better conditions[199]. In the absence of a national monetary policy, labour mobility can be a suitable response for any asymmetric shock by encouraging workers to move from low-employment countries to a high-one[200].

Transfer of payments or solidarity programs through fiscal integration. This would be used for creating a system based on budgetary transfers, such as funds or transfer of payments, that are sent from well-working economies to other regions facing serious difficulties with the aim of attracting investments, improving unemployment situation and finally, providing infrastructures. By sending transfer of payments, countries would be prevented from entering into recession as these funds would be used to support countries and absorb an adverse shock[201]. Basically, it would reduce the need of monetary independence[202].

---

[196] J. Sheridan, ''The consequences of the Euro'', cit., pp. 43-47.

[197] K. Reinert, *An introduction to international economics. New perspectives on the world economics*, New York, Cambridge University Press, 2011, p. 343.

[198] As one of the pioneers of the Optimum Currency Area Theory, R. McKinnon notes, factors mobility should be intended in two distinct groups: (1) geographic factor mobility among different regions and (2) factor mobility among industries. As also R. Mundell noted, an OCA can be formed when geographic factor mobility within a currency area is fostered while external flexible exchange rates are used for compensating the lack of factor mobility. In particular, the idea of applying flexible exchange rates is intended to overcome factor immobility depending on its size either small or large. On the contrary, if there is enough factor mobility, then both income and employment would be maximized. As R. McKinnon stresses, geographic mobility should be also balanced with a fair degree of size and openness of single-currency area. Lastly, if immobility between regions exists, this should be counterbalanced through monetary arrangements and in particular, by conceding their own currency so that more flexibility is provided to states to pursue adequate monetary and fiscal policies for ensuring internal stability. R. McKinnon, ''Optimum Currency Areas'', *The American Economic Review*, LIII, IV (1961), pp. 724-725.

[199] Factor mobility is an extremely important adjustment mechanism because both workers and citizens can migrate and move from one poor country to a prosperous region. Similarly, capital mobility should be considered as a stabilization tool as it helps reduce problems of balance of payments that could result in devaluations and capital losses. J. Jager, K. Hafner, ''The Optimum Currency Area Theory and the EMU'', cit., p. 316.

[200] B. Eichengreen, ''The Eurozone crisis: the theory of optimum currency areas bites back'', cit., p. 3.

[201] *Ivi*.

[202] As J. Frankel suggests, integration can be extended in the political sphere in order to reduce the need for

Having illustrated in brief the criteria of the OCA Theory, the Eurozone present a different scenario. The origins of the problem can be traced back to the Maastricht Convergence Criteria. Being focused on nominal convergence of the economies rather than real, they value factors that are not necessary for the creation of a monetary union neglecting a more appropriate evaluation on similar economies, business cycles and economic policy[203]. Hence, Maastricht Criteria provide an in-congruent analysis and economic foundation for creating a currency area to the extent that countries - with different economic structure, performance and business cycles – are now bound in the Eurozone.

By creating the Eurozone, both industrial specialization and integration of capital movements have been enhanced and promoted. However, without focusing on adjustment mechanisms, the chance of being further exposed to asymmetric shocks has simultaneously increased[204]. EMU is, indeed, trapped in its ability to act concretely and efficiently since labour mobility and transfer payments are extremely limited. Proper and efficient tools for responding adequately to asymmetric shocks and fulfilling national economics needs lack in the Eurozone. Once national sovereignty over monetary policy is lost, asymmetric shocks can be resolved only through fiscal national policies that are limited by the Stability and Growth Pact.

Surely, the launching of the Euro has increased the economic integration among the European states, between 1999 and 2018. Even though the rise in trade has not been the one expected, mobility of capital and integration of the financial markets occurred significantly, especially in terms of portfolio,

monetary independence and share the same economic priorities, such as fighting inflation and unemployment, among member states of the currency area. J. Frankel, ‘’No Single Currency Regime is Right for All Countries or At All Times’’, cit., p. 16.

[203] The convergence criteria focused on inflation, government budget deficit, government debt-to-GDP ratio, exchange rate stability by joining the Exchange rate mechanism (ERM) and long-term interest rate. However, by adopting a single currency and a single monetary policy, inflation rates and interest rates do automatically converge after the adoption and introduction of the common currency, if OCA criteria are met, regardless of whether convergence has been reached before. Maastricht criteria should have been focused on other and more important factors in terms of similar economic structure. J. Sheridan, ‘’The consequences of the Euro’’, cit., p. 48.

[204] As the macroeconomist J. Frankel suggests, as trade becomes more integrated, countries tend to specialize in production. Yet, specialization works against common currencies as countries become more vulnerable to internal and regional shocks and make candidates more worse to share a currency, in contrast to economic diversification which works in favour. Being anchored to a common monetary policy, countries are even unable to respond with countercyclical monetary and exchange rates policies. J. Frankel, ‘’No Single Currency Regime is Right for All Countries or At All Times’’, cit., pp. 29-33.

as it was hoped[205]. Besides this, foreign direct investments (FDI) have been enormously encouraged being investors attracted by Eurozone countries[206].

Capital flows have increased substantially financing low-productivity sectors resulting in real economic booms, i.e. housing and construction[207]. FDI have actually marked an increase for the Eastern and Central European countries**,** strongly supported by Germany, which established a bilateral trade partnership with those countries[208].

Rather than absorbing shocks, capital flows and free credit incurred into a destabilizing effect. The Periphery countries, benefitting from easy credit, have enjoyed a strong growth in domestic private spending. Especially, Spanish and Irish bank concentrated their lending in both housing and construction sectors, fueling housing bubbles that exploded in 2010[209].

If capital flows increased enormously, contributing to the boom and initial economic productivity, EMU is still 'plodding along' reaching the same or better benefits of other currency areas, such as USA.

Labour mobility has been quite limited due to linguistic and cultural barriers. Both elements prevent European citizens from leaving their native countries impacting directly labour market mobility complicating even more the situation[210]. Hence, European labour market is affected by a strong rigidity stressing that EU citizens and workers are less willing to move from one country to another one. As a matter of fact, asymmetric shocks tend to be extremely painful for some countries

---

[205] In 1999, the European Commission expected significant structural changes concerning both financial and international capital markets that would have contributed to the creation of a well-established market. By the time, it was already proved that one-third of the global private portfolio were held in Euros and would have gradually improved significantly. Similarly, 50% of the bonds were denominated in Euros confirming the fact that the EMU would have gradually experienced an expanding bonds and portfolios market. R. Zeppernick, ''Effects of the Euro on Trade, Capital Markets, and the International Monetary System'', cit., p. 283.

[206] Already in 1999, it was expected that increased competition among the Eurozone countries would have brought additional positive effects and benefits both on growth and on trade for both the EU countries and the non-. By the time, economists were convinced that Eurozone would have become a perfect ''destination'' for foreign direct investments on the basis that the effects promoting trade and growth would have outcome those of trade-diverging thanks to an increasing level of competition. *Ivi*,. 279.

[207] By introducing a single common currency, currency-risk was eliminated while interest rates decreased substantially. These two factors together fostered intra-euro capital flows, marked by an increase from 1 trillion Euro to a 10 trillion Euro in 2008. Eurozone recorded a further financial and capital account surplus in July 2018, with 6.13 billion Euro. Trading Economics, Euro-Area Capital Flows, https://tradingeconomics.com/euro-area/capital-flows, consulted on the 8th October 2018.

[208] German foreign direct flows mainly supported the supply chain and the production in countries such as Germany, Czech Republic, Hungary, Poland and the Slovak Republic, contributing to their stabilization and economic growth. J. Franks, B. Barkbu, R. Blavy, W. Oman, H. Schoelemann, ''Economic Convergence in the Euro Area: Coming together or drifting apart?'', *IMF Working paper*, XVIII, X (2018), p. 21.

[209] *Ivi.*, p. 20.

[210] The reasons why European citizens are not willing to leave their country is also related to underlying cultural shocks that result from migrating. A similar situation can generate both social frictions and political opposition. By considering another currency areas like the United States, capital and labour mobility are the main instruments employed for adjusting and tackling major difficulties. It is also true that the same cultural and linguistic factors are not present in the USA. J. Sheridan, ''The consequences of the Euro'', cit., p. 50.

experiencing higher unemployment rates and longer recession. Labour mobility within the Eurozone still remains modest even though Eastern countries have experienced an intense labour migration by joining the Eurozone and the EMU[211].

Surely, by improving certain conditions, such as labour mobility, for compensating and mitigating costs, and by applying structural reforms, the EMU could work better[212]. A further economic divergence rather than major convergence has emerged in the Eurozone market.

The EMU does not constitute a OCA for its great level of vulnerability and lack of instruments for responding to asymmetric shocks. Problems in the EMU might be resolved by means of national fiscal policies. Nonetheless, they are constraint by two factors: (1) the Stability and Growth Pact (SGP) that had the collateral effect of limiting fiscal measures that could be adopted for resolving the unemployment problem and (2) the ECB is strongly defending the SGP as an instrument for providing macroeconomic stability through the introduction of fiscal policies[213].

By not fulfilling the conditions required for respecting the OCA criteria and being the Eurozone countries insufficiently cyclically and structurally convergent, Eurozone countries are periodically affected by asymmetric shocks: divergent economic cycles and competition problems, high unemployment, income losses and increasing economic gap. To worsen the situation, the Eurozone is deprived of adjustment mechanisms for solving changing internal and external economic conditions[214]. Within this framework, the ECB, whose mandate is anchored to price stability, is usually considered the responsible for all the problems emerged, such as the wealth-gap among Eurozone countries. However, if there is someone to blame, this is not the ECB. The main problem is that most of the

---

[211] The percentage of EU citizens living in other countries has doubled over the years. Yet, the data are still low, above 3%. To worsen the situation, mobility amounts only up to 2% for the Eurozone countries. J. Franks, B. Barkbu, R. Blavy, W. Oman, H. Schoelemann, ‘’Economic Convergence in the Euro Area: Coming together or drifting apart?’’, cit., p. 19.

[212] As B. Eichengreen suggests, the theory of optimum currency area relies on several weaken points, which by pure coincidence reflect also the main shortcomings of the Eurozone. The OCA theory fails in explaining how banks can be a direct propagator of asymmetric shock and how a monetary union without a banking one can be enormously ill-balanced. Similarly, it does not mention the need of a central bank acting also as a lender of resort. Furthermore, it does not make any reference to the fact that a mechanism for restructuring debt might be desirable and finally, it does not put into light the fact that monetary union can be dismantled. B. Eichengreen, ‘’The Eurozone crisis: the theory of optimum currency areas bites back’’, cit., pp. 3-4.

[213] The Stability and Growth Pact (SGP) is a pact, introduced in 1997, that demands to pursue balance and surplus budgets (in case of economic growth) while limiting deficits up to 3% (in case of stall and economic recession). Similarly, government debt has to be contained within 60% of GDP. These measures applied together do not only limit possible fiscal manoeuvres for solving unemployment but they also have the controversial effect of limiting how fiscal market should operate. By issuing bonds for financing the European deficits, European governments are subject to different interest rate spreads which are a pure reflection of market expectations over the possibility of a sovereign default. Finally, even though the SGP was exalted as a source of macroeconomic stability, it actually evolved into a soft constraint. On the one hand, both France and Germany exceeded the 3% deficit limit; on the other, EMU countries exceeded the 60% debt limit. K. Reinert, *An introduction to international economics. New perspectives on the world economics*, cit., p. 343.

[214] M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions*, Houndmills, Palgrave Macmillan, 2015, p. 2.

countries joined the Euro in the hope of gaining more credibility and economic role both at European and international level[215].

The Eurozone was established not on economic merits but rather as the next step for completing European integration without sufficient political integration.

The EMU does not constitute an optimum currency area lacking the necessary economic adjustment mechanisms for overcoming asymmetries. Moreover, to worsen the scenario, other shortcomings and weaknesses have emerged over the years: the EMU is a monetary union but a fiscal disunion lacking a fiscal authority to balance the ECB powers[216].

Not only do countries differ in terms of economic performance and structure but certain regions are also exposed to higher and greater specialization, such as Germany. Hence, the possibility of being more vulnerable to asymmetric shocks increased in the Eurozone while revealing also the inadequacy of responding more promptly. Furthermore, despite the fact that measures have been already adopted for boosting a better harmonization and fiscal coordination, shortcomings still remain. This puts into light discrepancies among the member countries that stresses that the EMU is not a well-integrated currency union[217].

A monetary union is, indeed, not only about sharing a single currency and a central bank but it is also about sharing institutions for adopting policies that respond directly to instabilities and asymmetries within the area. By establishing a more flexible labour market, in terms of prices and wages, so as to adjust movements of labour force, the Eurozone would be more prone to shift towards an OCA. Eurozone countries should adopt structural reforms for readdressing successfully their economies while benefitting from greater performance, lower production costs and better adjustments in case of asymmetric shocks [218]. In order to overcome some difficulties, more political integration might be requested. Whether the EMU should proceed in the direction of a fiscal federalism is quite arguable, even though the Eurozone is already embedded with some federal features[219].

---

[215] J. Sheridan, ‘’The consequences of the Euro’’, cit., pp. 52-54.

[216] K. Reinert, *An introduction to international economics. New perspectives on the world economics,* cit., p. 343.

[217] J. Jager, K. Hafner, ‘’The Optimum Currency Area Theory and the EMU’’, cit., p. 320.

[218] The *Five President Report* suggests that relevant decisions in each area should be seen as a collective interest and apolitical package from which all member states can benefit, rather than being conceived as independent. Countries thus need to take steps individually and collectively for responding to asymmetric shocks. J.C Juncker, D. Tusk, J. Dijsselbloem, M. Draghi and M. Schulz, ‘’The five President’s report: completing Europe’s economic and monetary union’’, European Commission, Background documents on economic and monetary union, 2015.

[219] A fiscal federalism is characterized by four crucial criteria: (1) existence of non-monetary externalities, suggesting that by moving responsibilities to a centralized level, externalities can be internalized through better relevant policy instruments; (2) existence of returns to scale, which implies that by moving responsibility to a centralized level, benefits are larger; (3) existence of information asymmetries, suggesting that in some cases, decentralization of information is more efficient and less costly and (4) differences in policy preferences, which can emerge due to different identities, history and conditions. In similar cases, decentralization is a better solution. C. Wyplosz, ‘’The six flaws of the Eurozone’’, cit., p. 571.

2.1.2. Asymmetric shocks and divergences in the Eurozone

The Eurozone has succeeded in creating a credible monetary policy and deepening financial integration. Nonetheless, the cost of entry has implied the loss of monetary sovereignty and exchange rate policies[220]. This decision has weakened national economic management and structure which has been further aggravated by the rise of asymmetric shocks. By joining structural divergent countries into one currency area, asymmetries have been magnified and intensified[221].

Despite the initial expectation of leading economic convergence, the EMU has been driven by a simple rule in economic growth rates and current accounts: divergence. Hence, the Eurozone has revealed enormous discrepancies and shortcomings, being the Euro a burden and a limit for certain countries, such as Greece and Italy.

The whole framework has even been aggravated by two additional factors: (1) a failure of national governments in exercising sufficient fiscal discipline and applying structural reforms and (2) a lack of a fiscal distribution mechanism, which would allow to counterbalance poor and competitive countries and equalize regions suffering unemployment and declining incomes[222]. Hence, the introduction of a single monetary policy for different countries exacerbates even more instabilities and asymmetries since the real needs of the whole Eurozone economies are not fully satisfied[223].

Nonetheless, even though asymmetric shocks are an intrinsic feature of monetary union, they should be taken into account for establishing an effective and efficient monetary-policy setting. Asymmetries are, indeed, acknowledged as a direct propagator of divergences[224].

The European economic integration resulted in significant changes in the industrial sectors and European productivity. Industrial restructuring implies that some countries might become much more specialized than other, contributing to creating asymmetries[225].

---

[220] According to the economist J. Frankel, a central bank that intends to fight inflation should credibly fix exchange rates as fixing ensures a nominal anchor for monetary policy. Indeed, if monetary policy is established with discretion, then an inflationary bias will occur. Moreover, fixing exchange rates is beneficial for risk-reduction, elimination of transaction costs, avoidance of competitive depreciation and appreciation, and lastly, encouragement of both trade and investment. Yet, under fixed-exchange-rate system and complete integration of financial markets, as in the EMU case, monetary policy is almost powerless in case of recession. On the contrary, under floating exchange rates, an independent monetary policy can be pursued and answer more properly to economic upturns through monetary expansion or depreciation while working more promptly as an adjustment mechanism. Yet, under floating currencies, higher variability and uncertainty would appear on the market which would undermine trade and investment. J. Frankel, ‘’No Single Currency Regime is Right for All Countries or At All Times’’, cit., pp. 10-13.

[221] M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions*, cit., p. 1.

[222] J. Franks, B. Barkbu, R. Blavy, W. Oman, H. Schoelemann, ‘’Economic Convergence in the Euro Area: Coming together or drifting apart?’’, cit., p. 5.

[223] M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions*, cit., 2015, p. 1.

[224] As T. Monacelli explains, there exists three different types of asymmetries that are directly intertwined. *Asymmetries in shocks*, such as a specific country-disturbance, and *asymmetries in the economic structures* such as labor and price rigidity, are the consequence of the *asymmetries in business cycles* causing divergence and wealth-gap. T. Monacelli, ‘’Asymmetries and Eurozone policy-making’’ in R. Baldwin and F. Giavazzi (edited by) *How to fix Europe’s monetary union, views of leading economists*, , CEPR Press, London, 2016, p. 163.

Over the years, European countries have, indeed, witnessed a specialization in manufacturing sectors. Germany has addressed its production in high-quality manufactured products by investing conspicuously in the production of industrial and manufactured goods; France has focused its economy on infrastructures and transportation services while both Belgium and The Netherlands have privileged chemical industries[226].

Nonetheless, the Eurozone has marked a persistent and significant asymmetry in terms of unemployment rates and current account imbalances between the Core and the Periphery between 2000 and 2008[227]. One of the most surprising effects of the functioning of the Eurozone has been certainly the way in which the Eurozone countries have been exposed to a real divergence since the introduction of the Euro in 1999[228].

The Eurozone failed in addressing properly cyclical asymmetries due to a policy mistake committed by the ECB. The monetary authority applied for a long-time a policy without considering these asymmetries as if they did not exist. Hence, it has applied an anti-inflation policy basing it on an average rate among the European countries as if those were characterized by the same economy. As a result, certain countries such as Germany and Austria, have obtained most of the benefits while others like Portugal, Italy and Spain, have gradually lost in terms of wage and price competitiveness, entailing major welfare costs[229]. This situation has been further aggravated by two major factors: (1) national policies that have directly affected other Eurozone countries and (2) different speeds in reforming the structural institutions and conditions in the member countries, which still remain a national affair, highlighting also failure in coordination among the Eurozone countries[230]. Hence,

---

[225] B. Eichengreen, ‘’The Eurozone crisis: the theory of optimum currency areas bites back’’, cit., p. 4.

[226] B. Van Ark, ‘’Contrasts in Europe’s investment and productivity performance’’, in D. Acemoglu (edited by), *The Search for Europe: Contrasting approaches*, BBVA, Madrid, 2016, p. 9.

[227] Since the introduction of the Euro, current account differences have been much more evident. Countries, such as Germany and France, have experienced current account surpluses that have been compensated by the accumulation of current account deficits in other regions, such as Greece, Spain, Portugal and Ireland. B. Young, W. Semmler, ‘’The European Sovreign Debt Crisis: Is Germany to Blame?’’, *German Politics and Society*, XXIX, XCVII (2011), pp. 9-10.

[228] P. De Grauwe, ‘’The fragility of the Eurozone’s institution’’, *Open Economic Review*, XXI, I (2010), pp. 170-171.

[229] Germany has obtained the most benefits from the creation of the EMU. It has become the second most important exporter in the European market thanks to the competitive role it has reached. German exports grew substantially over a wide range between 1996 and 2008. This export expansion came at the costs of private demand that gradually decreased. B. Young, W. Semmler , ‘’The European Sovreign Debt Crisis: Is Germany to Blame?’’, cit., p. 10.

[230] Starting from 2003, Germany has adopted a policy focused on tight wage moderation, which has contributed to a strong decline in nominal wages in Germany, in contrast to the other Eurozone member countries, which kept a yearly increase around 3%. Germany has thus gained a competitive position thanks to a series of policies and measures introduced to reduce wage increases. Yet, they had the collateral effect of causing a deflationary pressure in the Euroarea. P. De Grauwe, ‘’The fragility of the Eurozone’s institution’’, cit. p. 170.

divergent gaps occurred resulting in low growth, low consumption and raising unemployment in the Southern Countries[231].

The ECB should have applied a monetary policy by targeting two important factors: (1) A *nominal rigidity-weighted average of inflation rates* of the member countries, considering internal structural frictions, price and wage degrees or the persistence of inflation in a country and (2) *Terms of trade-gap* focusing on deviation of trade. In the future, it should apply a policy which is much more focused on the composition of inflation and not only on an arithmetic average of inflation[232].

The European experience demonstrates that the introduction of a single currency might be beneficial to enhance intra-trade flows even though the internal market fails in bringing equal productivity among the Eurozone member countries. Nonetheless, the convergence that has resulted in the Eurozone has been imperfect in terms of productivity, wages, prices and also, in quality of institutions.

This divergence can be explained by considering two main factors: (1) countries with strong domestic demand, i.e. Italy, import more and depress their current account and (2) significant differences in terms of domestic demand and price competitiveness further weaken the Southern countries[233]. Moreover, unsustainable imbalances have occurred, especially in the Southern countries, because the introduction of a single monetary policy has mostly favoured the Core countries[234]. The northern European economies have benefitted from higher productivity affecting negatively the southern economies[235].

Members that intend to join a currency union should have a sufficient and satisfactory degree of real convergence. Otherwise, asymmetric shocks tend to result due to different economic developments which can bring to evidence an even larger gap between European regions. The Eurozone has thus led to the creation of the three distinct groups: «*the Core countries*», represented by Germany, Belgium, France, Austria, Finland and The Netherlands; «*the Semi-core countries*», embracing Cyprus, Italy, Luxembourg, Portugal, Spain and Slovenia and finally, «*the Periphery countries*», including Greece, Estonia, Ireland, Latvia, Lithuania, Malta and Slovakia[236].

Eurozone has been characterized by a decline in terms of income differentials and a weak real and structural convergence.

---

[231] J. Jager, K. Hafner, ''The Optimum Currency Area Theory and the EMU'', cit., pp. 315-316.

[232] T. Monacelli, ''Asymmetries and Eurozone policy-making'' in *How to fix Europe's monetary union, views of leading economists*, cit., pp. 164-165.

[233] B. Young, W. Semmler, 'The European Sovreign Debt Crisis: Is Germany to Blame?'', cit., p. 10.

[234] S. Micossi, ''What future for the Eurozone?'', *Luiss School of European Political Economy Brief*, VIII, (2015), p. 1.

[235] E. Amann, W. Baer, ''Market integration without policy integration: a comparison of the shortcomings of Mercosur and the Eurozone'', *Latin American Business Review*, XV, III (2014), p. 333.

[236] The Core and the Semi-core countries are characterized by a higher degree of structural convergence to the extent that they are assumed to be part of the OCA. This is in contrast to the Periphery affected by a very low degree of convergence and considered not to be part of the OCA. D. Rosati, ''Asymmetric Shocks in the Euro Area: Convergence or Divergence?'', cit. , p. 18.

Inflation rate is one of the factors that contribute to major divergences and consequently, to asymmetric shocks within a monetary union. Having the same or, at least, similar inflation rate is a requirement for a smooth stable functioning of the EMU.

Semi-Core and Periphery countries were already exposed to high inflation before joining the Eurozone and continued to suffer from it due to the introduction of flabby fiscal policies, private lending and the level of interest rates within the Eurozone[237]. Some Semi-Core and Periphery countries, such as Spain and Ireland, experienced enormous booms to the extent that they invested enormously in the construction and housing sectors. Portugal insisted on consumption-spending while Greece drained government spending thanks to lower borrowing costs. On the contrary, Germany opted for containing increases in nominal wages[238]. The German economy has thus been much more competitive and successful in terms of exports and growth that came to the detriment of the Semi-core and Periphery countries[239].

Two types of business cycles have thus emerged. On the one hand, countries with low wage-costs, export surpluses, low consumption growth and domestic demand, i.e. Germany and Austria; on the other, countries with high consumption, increasing wages, significant borrowing and current account deficits, i.e. Italy, Spain, Greece and Portugal. This asymmetric draw, where the spending boom was financed by money coming from the Core to the Periphery, had been stimulated by differences in real-interest-rates[240].

The magnitude of cross-border capital flows, financing public and private sectors between 2000-2008, should have been already seen as a clear indicator of asymmetries in the Eurozone. As a result, a destabilizing asymmetric shock resulted in a very dramatic situation when capital flows were interrupted. National economies and also banking and financial system faced a terrible scenario, which sooner or relater required policy response. Periphery countries suffered from enormous current account deficits while Core countries enjoyed accounts surpluses[241].

---

[237] By adopting one single level of nominal interest rate within a monetary union, the Semi-Core and Periphery countries could enjoy lower interest rates which promoted a boom both in consumption and investment that sooner or later would have manifested its terrible consequences. B. Eichengreen, ‘’The Eurozone crisis: the theory of optimum currency areas bites back’’, cit., p. 5.

[238] Germany insists on a moderate use of wages for increasing both competitiveness of the economy. Especially, the German economy focuses on flexibility of labour markets, reduction of non-wage labour costs and innovation. A similar approach ensures innovative and sound fiscal policies while benefitting from account surpluses and domestic savings. B. Young, W. Semmler, ‘’The European Sovreign Debt Crisis: Is Germany to Blame?’’, cit., p.10.

[239] Independent, Who is responsible for the eurozone crisis? The simple answer: Germany, Simon Wren-Lewis, https://www.independent.co.uk/voices/who-is-responsible-for-the-eurozone-crisis-the-simple-answer-germany-a6771536.html, consulted on the 20th October 2018.

[240] B. Young, W. Semmler, ‘’The European Sovreign Debt Crisis: Is Germany to Blame?’’, cit., p. 11.

[241] B. Eichengreen, ‘’The Eurozone crisis: the theory of optimum currency areas bites back’’, cit. , p. 5.

Since 2008, the Euro-area has been devastated by a severe full-blow financial crisis which marked the beginning of a more evident divergence in terms of labour and market competitiveness and also a different impact among the European countries[242].

The distribution of the asymmetric shocks in the Eurozone is extremely uneven as its intensity and impact are also related to national fiscal policies. Yet, these weaknesses might be solved by establishing limits to booms, major macroeconomic surveillance and banking regulation so as to monitor cross-border capital flows and current account deficits or imbalances[243].

Asymmetries and divergences are a defining feature of the Eurozone, which will continue to persist and exist until when a more effective and focused stabilization policy, which puts these cyclical asymmetries as central targets, is applied. A better coordination of macro-prudential policy might help solve asymmetries[244]. Similarly, fiscal policy – it being the primary stabilizing instrument- and fiscal coordination should respond to country-specific needs and deficiencies, in case of cyclical asymmetries, for enhancing macro-economic stabilization[245].

2.1.3. Expectations vs. reality: The European dismal performance

Eurozone has been facing enormous challenges since its establishment demonstrating that European economic integration has been much more difficult than expected. Probably, the project of integrating too many different economies and countries in one single currency block has been excessively ambitious. European countries are not different only in terms of economic and fiscal policy preferences but also national identities, cultures and histories[246].

At least in the first years of its establishment, EMU seemed to respect the principles on which it relies in the Treaties: economic and social progress, high level of employment and development[247]. Hence, it was thought that the EMU would have further promoted a real convergence, and not only a nominal

---

[242] D. Rosati, ‘’Asymmetric Shocks in the Euro Area: Convergence or Divergence?’’, cit., pp. 8-9.

[243] B. Eichengreen, ‘’The Eurozone crisis: the theory of optimum currency areas bites back’’, cit., p. 6.

[244] Fiscal policies should be used for compensating the loss of domestic monetary policy that can create enormous instability. Countercyclical fiscal policies can respond to inflation and interest rate. If inflation rises, interest rates decline by fostering domestic demand. However, by looking at the Eurozone, the model applied has been mainly focused on adopting a pro-cyclical fiscal approach. Hence, inflation has been higher and the balance lower. C. Wyplosz, ‘’The six flaws of the Eurozone’’, cit., p. 567.

[245] Fiscal policy, left at national level, is the only adjustment mechanism that can be adopted for solving regional imbalances. Fragilities and vulnerabilities in the Eurozone are quite evident. On the one hand, the ECB is unable to solve asymmetric shock through a single monetary policy as the latter does not satisfy national economic needs. On the other, fiscal policy is the only instrument for national governments to manipulate their economy for achieving the desired level of income and output through contractionary or expansionary policies. Yet, they are limited by numerical parameters at European level. M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions*, cit., pp. 125-130.

[246] A. Alesina, G. Tabellini, F. Trebbi, ‘’Is Europe an Optimal Political Area?’’, *Brooking paper on economic activity*, XII, I (2017), pp. 169-171.

[247] Current Art. 2, Consolidated version of the Treaty on the Functioning of the European Union, Official journal, C326 [2012].

one, among the European members[248]. However, even though convergence should occur in a currency union, divergence has appeared in the Eurozone in terms of different productivity, employment rates and account imbalances.

Growth within the Eurozone has not been uniform: Germany and France did great; Eastern and Central European countries have been able to catch-up with the better and well-organised countries thanks to the support of German capital; others, such as Italy and Portugal, have plodded along in an attempt to increase productivity and growth, while Spain and Greece faced a difficult competitive position. Moreover, the Semi-core and Periphery countries have experienced increasing current account deficits being hindered from devaluating their currency to reobtain a competitive position while the Core countries have enjoyed major surpluses[249]. A similar scenario raised questions whether an effective convergence will be ever concretely reached in the Eurozone[250].

Generally speaking, the performance of the Eurozone has been dismal considering several factors due to rigidities of Euro and significant global changes[251].

The introduction of the Euro seemed to be associated, at least in the first years, with a yearly output growth which implied that an effective conformation across the European countries occurred (thanks probably to the Single Market)[252]. This initial period of economic integration coincided, indeed, with

---

[248] By considering real convergence, European member countries should experience a narrowing in their differences in terms of productivity and structural conditions. This implies overcoming the unsatisfactory performances by encouraging also the semi-core and periphery countries to catch up with the more organized core countries. E. Marrelli, M. Signorelli, ‘’Convergence, Crisis and unemployment in Europe: The need for innovative policies’’, *Croatian Economic Survey,* XVII, II (2017), p.8.

[249] The more favourable position of Germany can be associated with two main factors: (1) the depreciation of real exchange rates by 10% in Germany, while appreciation in Italy and Spain by 10-15%; (2) the introduction of important structural reforms both in labour market and in the welfare services, allowing in this way to experience a more competitive position at the price of loss in the fiscal discipline, though for a limited period of time. E. Marrelli, M. Signorelli, ‘’Convergence, Crisis and unemployment in Europe: The need for innovative policies’’, cit., pp.11-12.

[250] The European Commission is convinced that the macroeconomic stability based on price stability and fiscal discipline, removal of exchange-rate risks, reduction of uncertainty and instability through inflation and interest rate constraints promote trade, growth and investment. However, contrasting opinions claim that this package of measure has a negative impact as a result of the deflationary effects caused by restrictive monetary policy and fiscal policies introduced simultaneously by several countries. *Ivi*, pp. 10-11.

[251] Euro has been a burden for some economies, such as Greece. Being deprived of a national monetary policy, Eurozone countries could not devaluate their currency nor decreasing interest rates that would have allowed competitive power, recovery and better conditions than the ones imposed by the ECB. The latter applied higher interest rates in times of crisis that contributed to slower growth and increasing deficits causing painful consequences. However, for other countries, such as Finland, the dismal performance is also associated with the rise of big giants that were more competitive in terms of technology and productivity, such as the US Apple, that led to the collapse of the Finnish Nokia. J. Stiglizt, *The Euro: How a Common Currency Threatens the Future of Europe,* New York, Norton & Co Inc., 2016, pp.63-64.

[252] As the macroeconomist J. Frankel notes, promoting both trade and investment were at the very basis for creating an European monetary union. Yet, there is still not sufficient testing that confirms that both trade and investment are actually boosted by a complete and full monetary union even though the elimination of exchange rate uncertainty and currency transaction costs surely enhance and stimulate trade. J. Frankel, ‘’No Single Currency Regime is Right for All Countries or At All Times’’, cit., pp. 10-11.

liberalization and free movement of goods and capital[253]. Nonetheless, the overall Eurozone's growth has been quite disappointing between 1999 and 2008 as the growth average amounted below 2%.

A similar outcome can be explained through the Walters Critique by looking at the rates differential that followed after the launching of the Euro[254]. Hence, higher inflation rates endangered both external competitiveness and domestic demand for goods and, gradually, asymmetric cyclical positions emerged. As a result of inflation differentials, some countries, such as Germany, enjoyed a major competitive role, increasing economic growth and activity and current account surplus, while others, such as Ireland, Greece, Spain and Portugal have suffered from a progressively deteriorating competitive role, weaker productivity growth, higher inflation, resulting in growing deficits.

By having inflation differentials in the Eurozone, the real convergence of the Euro-countries, which relies on income, productivity and growth, was seriously hampered, undermining potential growth and competitiveness of certain high-inflation countries.

Due to labour rigidity within the Eurozone, the competitiveness of these countries was further compromised in 2008. Southern countries suffered an even worst scenario in terms of deficits, due to import contraction worsening their account imbalances[255].

The overall Eurozone scenario highlights that member are hit differently by economic shocks where both Euro and economic integration are a direct propagator of this divergence[256].

During the first decades, Eurozone countries have undergone macroeconomic imbalances in the balance of payments (BOP) due to national economic policies introduced by some Core countries (Germany, Austria and the Netherlands). They increased their competitiveness in exports by reducing wages through an *internal devaluation*[257]. On the contrary, some periphery countries, such as Greece,

---

[253] By introducing the SEA, the early phase of European economic integration corresponding to the period between 1980s and 1990s, experienced an effective economic convergence, probably related to the fact that poorer countries, such as Spain and Greece, found themselves initially in such a position to catch-up with the more modern economies. Nominal convergence in terms of GDP has been achieved thanks to the integration of economies, through customs union and single market, that have been emerged independently from the introduction of the single currency. A. Alesina, G. Tabellini, F. Trebbi, ''Is Europe an Optimal Political Area?'', cit., p. 180.

[254] According to the Walters Critique, by fixing exchange rates, inflation rates will divergence because nominal interest rates will equalize in contrast to the real interest rates. These will be even more higher for countries suffering already from inflation. As a result, by introducing a common monetary policy, inflated countries will suffer from higher inflation and lower interest rate. On the contrary, low-inflated countries will enjoy a decreasing inflation. C. Wyplosz, ''The six flaws of Eurozone'', p. 563.

[255] J. Franks, B. Barkbu, R. Blavy, W. Oman, H. Schoelemann, ''Economic Convergence in the Euro Area: Coming together or drifting apart?'', cit., p. 22.

[256] Trade integration can bring significant changes in terms of prices and structure of production. As a result, some countries tend to specialize in specific sectors resulting in divergence and different economic coordination. Sharing a single common monetary policy can promote and lead to conflicts. A. Alesina, G. Tabellini, F. Trebbi, ''Is Europe an Optimal Political Area?'', cit. p. 181.

[257] It should be stressed that, initially, Germany's entry was not brilliant due to high levels of long-term unemployment and slow growth to the extent that it was labelled as *the sick man of Europe*. Suffering from a blocked society, it was only under the German Chancellor, Gerhard Schröder, that some changes occurred. By launching a multiphase program (between 2003-2005), it opted for a labour market liberalization and

Spain, Ireland and Portugal, lost competitiveness since they allowed wages to increase without containing. Thus, they suffered from account deficits[258].

Deflationary impulses, caused directly through depreciation in the Core countries, associated to a structural break in terms of production contributed to a dismal growth in the monetary union. An inefficient use of factors of production in certain regions (Italy) slowed down economic growth, investment and employment, contributing to an increase in unemployment[259]. Hence, the overall Eurozone performance has not been brilliant in terms of both productivity and growth[260].

Especially, in the latest years, the Eurozone has jumped into a real stagnation, as depicted in Figure 1.1. This scenario has been also worsened by the fact that some countries, such as Greece and Italy, have grown modestly in the latest years while others, such as Germany, are performing successfully. A similar outcome might have occurred due to the impact of coordinated fiscal policies through the austerity packages adopted in times of crisis that led to a feeble European economy[261]. These hindered both adjustment shocks and economic recovery, even though contrasting views appeared[262].

---

benefit cuts thus restoring German competitiveness and transforming it into an *Exportweltmeister* (a world export champion). Moreover, the unemployed came back on the labour market while wages for unskilled workers decreased. Lastly, an important source of competitive advantage was achieved by outsourcing production in both Eastern and Southern Europe. These factors, accompanied by Angela Merkel's policy based on fiscal consolidation and especially, the adoption of a *debt brake* (since 2006) for avoiding debt expansion, contributed to German's recovery and growth. A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, pp. 105-106.

[258] Considering certain states, such as Greece, they joined Eurozone with price and income levels lower than the average. Benefiting from lower interest rates, their price and income level exploded rapidly. Thus, its growth has been driven by consumption that gradually led to public debt and deficit, recording account imbalances. D. Hodson, ''Policy Making under Economic and Monetary Union: Crisis, Change and Continuity'' in H. Wallace, M. Pollack, A. Young, (edited by), *Policy-Making in the European Union*, Oxford, Oxford Press, 2015, p. 175.

[259] According to IMF's projection of 2015, the fall in productivity and growth has been a direct cause of the decline in investments, associated with the introduction and application of new technologies that contributed to an increasing unemployment rate. Other reasons for a slower productivity are related to the quality of institutions and governance, which might have affected adversely Eurozone economy. IMF World Economic Outlook (WEO), *Uneven Growth Short- and Long-Term Factors, World Economic and Financial Surveys*, Conventional Paper, Washington, 2018, pp. 74-78.

[260] In the early years of the currency area, European growth accelerated and inflation remained moderate. Yet, after the introduction of the single currency, Euro-members experienced an initial increase in prices. To worsen, what really worried by the time, was the lack of a currency adjustment that contributed to build-up of imbalances and divergences among countries. A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, New York, cit., p. 104.

[261] The introduction of austerity measures in depression times can be self-defeating, damaging both economic growth and leading to higher debt ratios. A similar situation occur as: (1) external demand is depressed as a result of fiscal coordination and consolidation; (2) fiscal imposition and tightening do not have a direct impact on interest rates and (3) private spending, household and firms' liquidity are seriously constrained and worsened by higher unemployment. E. Marrelli, M. Signorelli, ''Convergence, Crisis and Unemployment in Europe: The need for innovative policies'', cit., pp. 29-30.

[262] There are some countries, such as Germany, that blame rigidity of labour, corruption and the reluctance in reforming the tax system as the primary factor for a slower and detrimental performance. In their mind, by overturning the system, better and more efficient solutions can be adopted. J. Stiglitz, *The Euro: how a common currency threatens the future of Europe*, cit., p.60.

Hence, the last decades have suffered from lower productivity, lower income, lower growth, decreasing standards of living, increasing inequality and poverty showing more pronounced results in certain regions, in contrast to the expectations that the Euro would have enhanced a more productive, competitive and cohesive Europe.

Apparently, the Eurozone has lost more than 10% of its GDP between 2002 and 2014, amounting to a loss of 6 billion euros, as a result of the application of wrong monetary policies[263]. A similar framework highlights two important points: (1) the Eurozone is not optimal but rather imperfect and (2) the situation could worsen if European countries do not opt for innovative policies[264]. This situation could be resolved by increasing labour and wage flexibility through internal devaluations in an attempt to restore competitiveness or through a contraction of the fiscal policy. Starting from 2014, the ECB is fighting to relaunch both growth and productivity through the adoption of unconventional policy measures[265].

Surely, rebooting Eurozone economy is necessary. Initiatives should thus not be taken only at national level but also at European level, through structural changes in the economies to stimulate private investments, growth and recovery. Otherwise, Europe will risk to be stuck in a fragile construction with low growth and high unemployment.

The Eurozone has reported a very unstable and dramatic situation with regards to unemployment. By launching the Euro, member states have implemented a number of reforms concerning employment-protection that had multiple-effects: (1) higher participation rates; (2) falling unemployment and (3) falling prices. These provision taken together contributed, at least initially, to convergence in unemployment rates. Unfortunately, the situation changed dramatically when the financial crisis hit Europe resulting in different conditions from region to region. No sign of convergence was marked again[266].

Generally speaking, the Eurozone has lost more than ten million jobs since the launching of Euro. The performance has been further exacerbated since 2008 marking a more catastrophic scenario: (1) the participation rate in the workforce has gradually decreased, which is directly linked to the fact that individuals who were initially looking for a job simply stopped doing, feeling discouraged[267]; (2) the

---

[263] M. Baldassari, *The European roots of the Eurozone crisis – Errors of the past and needs for the future*, Cham, Palgrave Mcmillan, 2017, p. 310.

[264] According to the latest IMF's projections: «The recovery in the euro area is projected to pick up slightly from 2.3 percent in 2017 to 2.4 percent this year, before moderating to 2 percent in 2019. The forecast is higher than in the October WEO by 0.5 and 0.3 percentage point for 2018 and 2019, respectively, reflecting stronger-than-expected domestic demand across the currency area, supportive monetary policy, and improved external demand prospects. Medium-term growth in the euro area is projected at 1.4 percent, held back by low productivity amid weak reform efforts and unfavorable demographics». IMF World Economic Outlook (WEO), *World Economic and Financial Survey*, Occasional paper, 2018, p. 76.

[265] M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions*, cit., p. 1.

[266] D. Hodson, ''Policy Making under Economic and Monetary Union: Crisis, Change and Continuity'', cit., p. 185.

[267] It is often said that Eurozone applied in the past a policy, based on a super-appreciation of the Euro, which

unemployment rate has significantly increased, as depicted in Figure 2.1 and (3) Eurozone debt-to-GDP-ratio has been growing as a result of the austerity policies applied since 2011-2012[268].

The reduction in the participation rate was, however, more or less distributed proportionately and homogeneously, affecting the countries in a similar way. The Eurozone has suffered from an impressive loss of employment, around 7-8% of its GDP in the period between 2002-2014, with Greece, Italy, and Ireland suffering the most, followed by France and Spain recording a limited effect[269]. Some additional and worrying indicators refer to both long-term unemployment and youth unemployment within the Eurozone, as depicted in Figure 3.1, with a peak of 24.1% in 2013[270].

The crisis impact has been very deep on younger people, that are directly affected due to unstable jobs thus hampering European social integration. This situation was even more disturbing for the countries that were seriously and badly hit by austerity measures - Spain, Greece and Portugal - and that are now trying to catch up.

Since the financial crisis, the Eurozone has been affected by a deceleration in terms of growth and productivity, marking a collapse in investments expenditures. Moreover, austerity measures have also brought forms of increasing poverty and inequality as austerity packages were not accompanied by investments for creating jobs and compensating losses. A similar phenomenon occurred due to an indirect contagion influencing Eurozone countries that were not 'cured' with austerity measures[271].

---

caused enormous negative effects on the whole area. On the one hand, it damaged the already internal weaknesses of the Eurozone countries and on the other, it brought a proportionally distributed loss in the countries. The super-appreciation of the Euro has been held responsible for cuts in growth, losses in GDP, higher employment rates and negative public finance balances. M. Baldassari, *The European roots of the Eurozone crisis – Errors of the past and needs for the future*, cit., p. 336.

[268] E. Marrelli, M. Signorelli, ''Convergence, Crisis and Unemployment in Europe: The need for innovative policies'', cit., p. 22.

[269] M. Baldassari, *The European roots of the Eurozone crisis – Errors of the past and needs for the future*, cit., 2017, p. 319-333.

[270] Most of the austerity reforms applied focused on labour market. These reforms have thus entailed enormous consequences for workers in terms of social benefits, insecurities, lower wages and stability. In the Eurozone, unemployment rate reached 12% in 2013, where the highest level could be found in Greece (27.5%), in contrast to 2018 (20.2%); Spain (26.1%) in contrast to 2018 (15.2%). Youth unemployment is even worse, amounting proximally up to 24% in 2013 while 16.9% in 2018. The highest values were seen in: Greece (58.3%) in 2013 while (43.2%) in 2018; Spain (55.5%) in 2013 while (33.8%) in 2018, Italy (40%) in 2013 while (31.9%) in 2018. The exception in the Eurozone is represented by Germany, experiencing lower level of unemployment rate, (5.2%) in 2013 and (3.4%) in 2018. Similarly, youth unemployment amounted up to 7.8% in 2013 while 6.1% in 2018. Germany has thus undergone a prosperous time since 2009 relying on positive real growth, decreasing unemployment rates and a balanced budget. Statista, Youth unemployment rate in Europe (EU member states) as of May 2018 (seasonally adjusted), https://www.statista.com/statistics/266228/youth-unemployment-rate-in-eu-countries/. Statista, Unemployment rate in member states of the European Union in June 2018 (seasonally adjusted), https://www.statista.com/statistics/268830/unemployment-rate-in-eu-countries/, both consulted on the 11th October 2018.

[271] J. Franks, B. Barkbu, R. Blavy, W. Oman, H. Schoelemann, ''Economic Convergence in the Euro Area: Coming together or drifting apart?'', cit., p. 11.

Macroeconomic imbalances badly hit the Eurozone countries due to lack of fiscal discipline in their current accounts. Surely, this factor further contributed to a dismal performance in the Eurozone highlighting high government debts even though the early years of the EMU coincided with a general improvement of budget deficit, being below 3% of GDP. However, generally speaking, Eurozone countries have suffered from higher public deficits and public debt accumulation, as depicted in Figure 4.1., with enormous repercussion in Spain, Greece, Portugal and Ireland[272].

The Eurozone has been affected by a dispersion of GDP well before the global financial crisis, in 2008. Rather than stopping, the currency area has continued following this wave, affecting also those countries that kept low debt and low deficit[273].

The European economic integration was born with the primary aim of favouring harmonisation of policies, such as market and financial regulation, and boosting economic prosperity. Paradoxically, what has effectively occurred is rather increasing divergence, unemployment and lower growth.

By abolishing trade barriers, Eurozone countries have specialized in specific sectors to compete with the other countries. EMU and Eurozone membership have not together encouraged the implementation of new structural reforms. Rather than enhancing flexibility and productivity, labour tax policies have mainly diverged, creating different incentives for employment across countries and impacting directly the economic growth[274].

Europe is at a very crossroad as the only way for improving the current situation is either by promoting deeper and further integration or by stepping back to the Single Market removing the single currency, which seems costly and unfeasible. Economists think that the next step to be done is to proceed in the direction of a political union but, before doing it, it is actually necessary to develop a strong European sense of belonging and European identity which might decrease reciprocal distrust among the countries. Moreover, further steps in the direction of political union seem hard to be reached as it would imply a major transfer of sovereignty[275].

Giving up national monetary policies in favour of one has affected countries in different ways: higher levels of deficit, public debt and unemployment rate. The divergence occurred during the crisis years

---

[272] M. Baldassari, *The European roots of the Eurozone crisis – Errors of the past and needs for the future,* cit., pp. 336-351.

[273] E. Marrelli, M. Signorelli, ‘’Convergence, Crisis and unemployment in Europe: The need for innovative policies’’, cit., pp. 18-19.

[274] By creating the Euro-area, a reduction in terms of competitiveness has occurred in product markets over a range between 1998 and 2013. However, in terms of labour tax law, the dispersion has been much more evident with the introduction of the Euro. From 2009 on, labour started converging, reaching the peak in 2015. J. Franks, B. Barkbu, R. Blavy, W. Oman, H. Schoelemann, ‘’Economic Convergence in the Euro Area: Coming together or drifting apart?’’, cit., p. 21.

[275] One of the reasons why the European political union seems a far reality is related to the strong heritage of nationalism, stressed by different languages, history and identity, which still feed some mistrust and resentment among European countries. The situation is even further complicated and worsened by a nationalist and populist right-wing sentiment that is on the verge in the European countries, which surely will prevent and hinder further moves towards a more tightened union. A. Alesina, G. Tabellini, F. Trebbi, ‘’Is Europe an Optimal Political Area?’’, cit., p. 206.

stressed the difficulty of the Eurozone in promptly reacting and responding to severe economic downturns[276].

[276] E. Marrelli, M. Signorelli, ‘’Convergence, Crisis and unemployment in Europe: The need for innovative policies’’, cit. p.22.

Figure 1.1. GDP Volume Growth in the Eurozone 1999-2018[277]

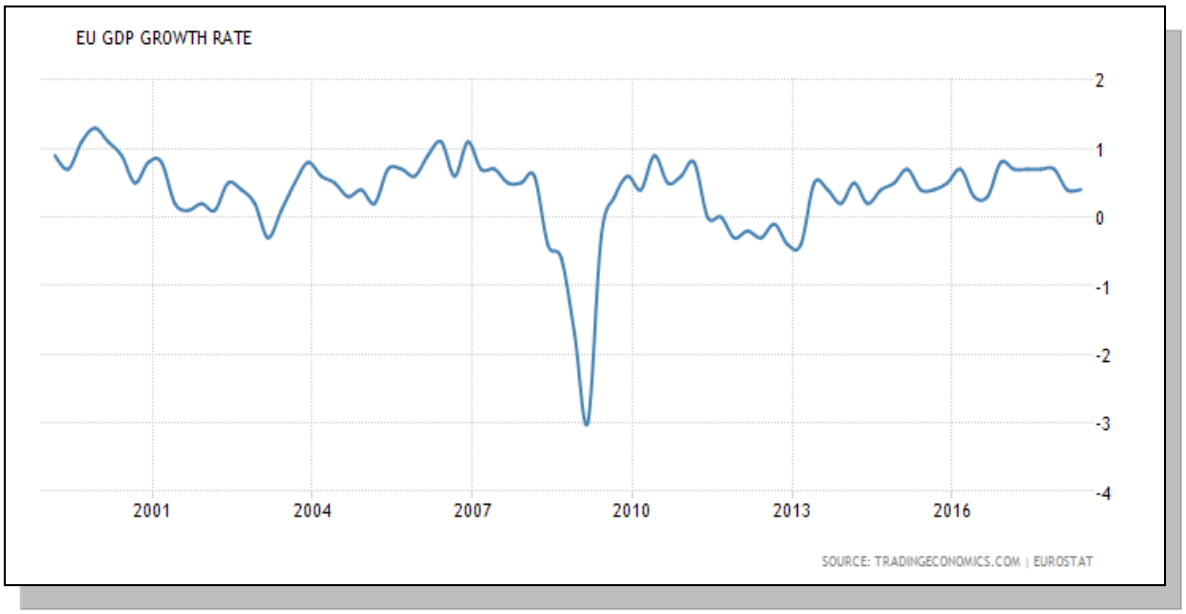
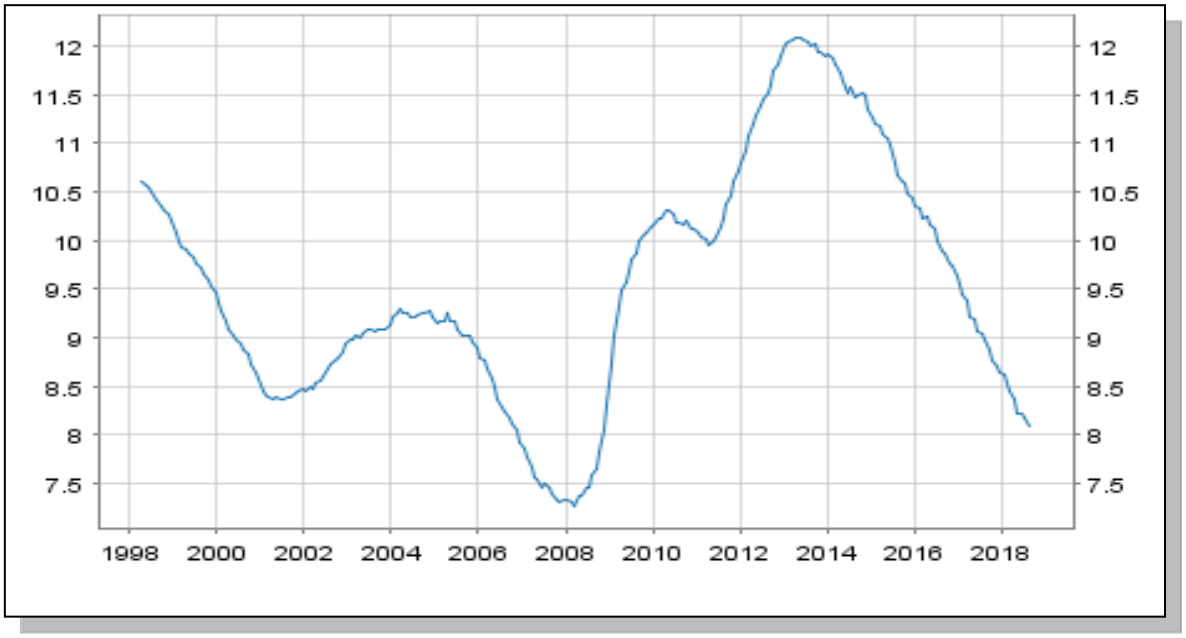


Figure 2.1. **Unemployment rate in the Eurozone (as a % of labour force) 1998-2018**[278]

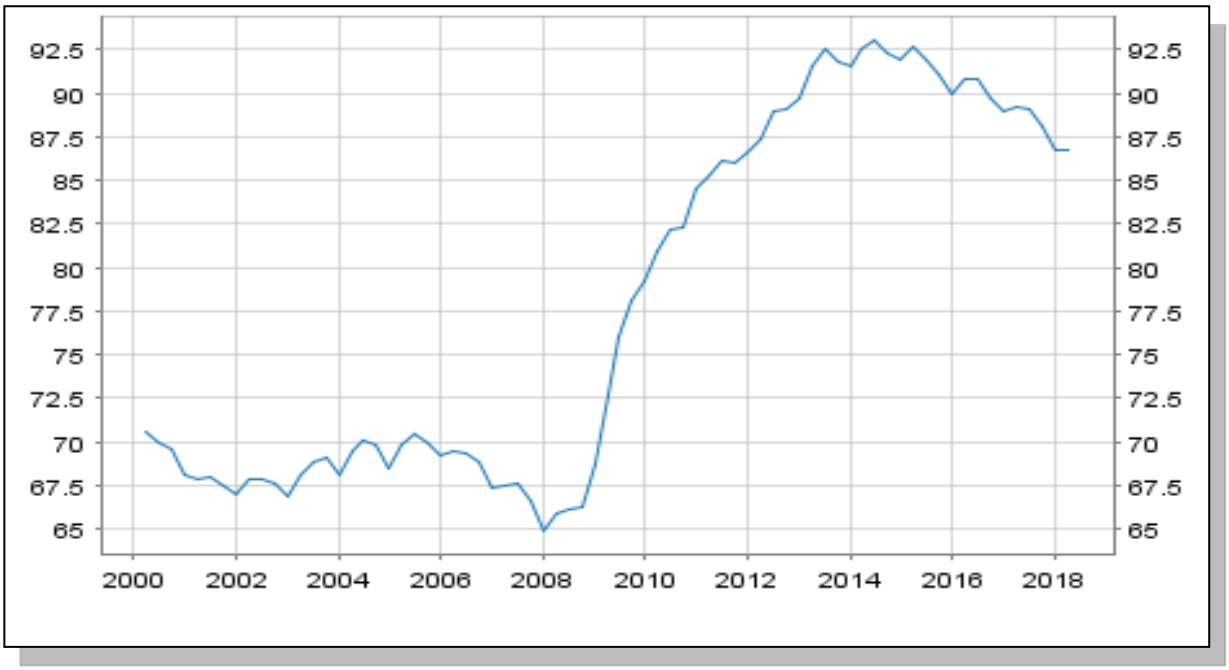


[277] Trading Economics, EU GDP Growth Rate, https://tradingeconomics.com/euro-area/gdp-growth, consulted on the 17th October 2018.

[278] European Central Bank, Statistical Warehouse, Parameters and Trasformation of the Unemployment in the Eurozone from 1999 to 2018, http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=132.STS.M.I8.S.UNEH.RTT000.4.000, consulted on the 17th October 2018.

Figure 3.1. Youth Unemployment rate in the Eurozone 1999-2018[279]

Figure 4.1. **Government debt (consolidated) (as % of GDP) in the Eurozone 1999-2018**[280]



[279] Trading Economics, Youth Unemployment Rate, https://tradingeconomics.com/euro-area/youth-unemployment-rate, consulted on the 17th October 2018.

[280] European Central Bank - Statistical Data Warehouse, Government debt (consolidated) (as % of GDP), http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=325.GFS.Q.N.I8.W0.S13.S1.C.L.LE.GD.T._Z.XDC_R_B1GQ_CY._T.F.V.N._T, consulted on the 17th October 2018.

PART TWO

Boom and Bust:

Asymmetric propagation of financial crisis

2.2. From the USA to the Eurozone: Stuck in the crisis

Starting from 2007-2008, the world economy underwent a tough period marked by one of the most dramatic crisis that originated in the United States through a subprime meltdown due to the collapse of Lehman Brothers[281]. 2008 marked a very decisive break in investment and consumption while a rise in unemployment. Initially, it was though that this mortgage crisis was limited to an American national crisis but as recent studies showed, the American securitized mortgage system was actually designed to attract foreign capital into the US financial markets.

Foreign banks and especially, European banks promptly took the opportunity to the extent that they end up holding a large part of American mortgage debt. The largest purchasers of US assets were, indeed, European banks. Inevitably, an intricate and sick circle of financial flows between Europe and the United States created a very dependent financial and trade system. A large quantity of dollars, deriving from the US markets funds, were invested in European debts and commercial papers of European banks. What emerged was a multicurrency balances sheets of European banks that played a crucial role and that sooner or later, would have manifested its terrible consequences[282].

In practice, global finance was dominated by an Euro-American axis where European banks were working not only as a *safe channel* but also as a *hedge fund* contributing to the creation of an international-transatlantic banking system.

---

[281] The mid-2000s were characterized by a real housing boom, pushed by low interest rates introduced by the Federal Reserve. The housing sector and real estate business expanded enormously for a while. This allowed individuals with poor credit to borrow home loans, as lenders extended mortgages also to individuals who could not otherwise qualify for a traditional loan. However, beginning in 2007, high-risk subprime mortgages defaulted as real estate bubble exploded. This lead to one of the most severe recessions in the human history. Subprime mortgages were based on adjustable-rate loans with a reasonable interest rate that could be reset to higher interest rate. This occurred and led to a growing number of defaults. The subprime meltdown brought some banks to bankruptcy being borrowers unable to repay back their loans. One of these was Lehman Brothers being involved in the subprime market. Once the US housing market collapsed, Lehman Brothers followed. Its demise induced financial crisis that affected global financial markets in 2008. Investopedia, Subprime meltdown, https://www.investopedia.com/terms/s/subprime-meltdown.asp; Investopedia, The collapse of Lehman Brothers, https://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp, both consulted on the 22nd October 2018.

[282] As A. Tooze brilliantly illustrates, a large portion of American debt and houses were held by foreign investors. Indeed, when the US mortgage securitization exploded in 2006, a third of the Mortgage Backed Securities (MBSs) were held by both European and British banks as they had both a good reputation among rating agencies. On the contrary, in 2007, European banks dominated the market to the extent that almost two thirds of American commercial papers had European sponsors, among which Germany and especially, Deutsche Bank were the most prominent and one of the main players of Wall Street. To worsen, European banks started not only dealing with this type of securities but also generating and creating mortgage securities on the American soil. Indeed, they were borrowing dollars to lend dollars to fund their mortage-holdings. A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, cit., pp. 83-88.

Once Lehman Brothers collapsed, serious repercussions were unavoidable. The banking sector felt the pressure due to the vast volume of credit injected in the system and complex dependency. Initially, a credit crunch propagated resulting in market freezing and dry up of loans. Yet, the instability, that was initially originated in the housing sector, soon spread in the financial and banking system and lastly, in non-financial corporations and households. This created a very unstable scenario that halted global growth as the global synchronization was extraordinary. Lasting worst consequences did not reach only China and the emerging countries, such as India, but also the Eurozone, which initially was considered a safe heaven.

The Eurozone crisis started as a sudden stop of foreign capital inflows being contaminated by the United States. Yet, starting from 2010, it actually suffered from its own authentic crisis - caused by itself - which affected both public finances and national sovereignties. Initially, by summer 2009, European and American economies gave sign of recovering thanks to a bank-cauterization and huge injection of liquidity (followed by a severe level of austerity) that worked as automatic stabilizers, at least in the US.

One of the main misfortunes of the Euro was that it was born in one of the greatest credit bubble of the human history. Global credit expansion, occurring during the 2000s, attracted enormously European banks. Indeed, most of the French, German, Italian and Benelux banks invested an immense quantity of liquidity in the financial system being facilitated by the lack of cross-border controls and currency risk. Inevitably, both cross-border lending and finance exploded.

In this context, Ireland, Greece and Portugal were the countries that suffered the most severe consequences in terms of budgets. This flows of liquidity, driven by the logic of bankers, had a double effect: on the one hand, it contributed to fuel real estate booms and bubbles in Ireland, Spain, Greece where the combination of credit growth and house price inflation was explosive; on the other, it led to fiscal imbalances in the Eurozone (booming surpluses and healthy tax revenues)[283].

European banks and the Euro seemed prone to fail. The global financial crisis hit many Eurozone countries in a different, selective and asymmetric way given the predominance of both bank-system and bank-financing[284]. However, it was quite reasonable to think that sooner or later, the Eurozone

[283] As A. Tooze highlights, securitization had been part of mortgage finance in Europe. Yet, starting from the early 2000s, this method exploded and most of the asset-backed loans went to Greece, Spain and Ireland. By making a deep analysis, it emerges that Germany was not dominating the European financial system, even though by the time, it was the major European capital export leader. Rather, France, the Benelux countries and Ireland were the main hubs of financial flows. Especially, London hosted the major global financial partners for the Eurozone countries with France and the Benelux countries acting as financial channels by injecting liquidity and funds in the Periphery countries. A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, cit., p. 115-116.

[284] The quantity of cross-border capital flows was so enormous that foreign bank-lending in the Periphery countries – Greece, Ireland and Spain – amounted up to 2.5 trillion dollars. Of this amount, 500 billion Euros of French and German banks were in danger. Since this flow fostered a real estate inflation, as soon as the crisis hit, a painful deflation occurred. On the contrary, Italy, Belgium and France's public debt started raising concerns. To worsen the scenario, mortgage borrowing contracted, house prices collapsed and lastly,

would have been hit by a crisis due to imperfections and flaws in the architecture and framework: an inadequate central bank, a weak fiscal discipline due to the violation of the Stability and Growth Pact (including Germany and France in 2003), high debt levels, insufficient labour mobility, lack of a lender of last resort, the absence of both a risk-sharing mechanism and a common system of benefits and lastly, the inexistence of any provision to deal with banking crisis[285].

The crisis would have revealed that the Eurozone was a monetary union with highly integrated and unified financial markets but without an adequate banking union and structure since the ECB was presiding over the financial system from a very distant position.

It would be too simplistic to attribute the Eurozone financial crisis to the ECB only. The surrounding structure was responsible as well. Yet, once the Euro was launched, the ECB thought that having a single currency implied also applying the same interest rates. Acting in this way, a convergence in bond yields occurred that allowed to some countries such as Greece, Portugal and Spain to borrow on more preferable terms than in the past[286]. The ECB could have done much more to hinder credit booms, for instance by increasing or at least, diversifying interest rates. In any case, its effort should have been supported by substantial economic policies, such as lending rules, tighter fiscal policy or rules on banking system.

Once the crisis erupted, the Eurozone was badly affected by enormous difficulties since international investors lost confidence and trust in European banks and sovereigns over their ability to repay back their debt, which in most cases was mainly held by banks.

The Eurozone was three times more overbanked that that the United States as Eurozone financial system is mainly bank-based. The global financial crisis paved the way for a more specific Eurozone debt crisis – in the private sector - which emerged due to systemic failures in both the Eurozone architecture and in the global and economic political order[287].

---

financial market became more unstable. Net wealth per person fell by almost 10% in Spain while in Ireland, house prices, that initially quadrupled between 1994 and 2007, halved between 2008 and 2012. Last but not least, Germany suffered from a severe fall in export and traded goods between 2008 and 2009 (amounting up to a 34% net cut). A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, cit., pp. 167-170; pp. 334-335.

[285] The ECB was surely established as the most inadequate and remote central bank being prevented from monetizing issued government debt. The reasons for this decision are mainly two: (1) keeping its independence and (2) avoid the use of the central as a fiscal policy. Moreover, it was established as a very unfair bank due to an excessive focus on anti-inflationary policies. Lastly, the ECB did not hold a large quantity of debt, in contrast to other central banks, as debt was mainly held and bought by European banks. C. Wyplosz, ‘’The six flaws of the Eurozone’’, cit., p. 562.

[286] As A. Tooze highlights, no public debt boom occurred after 2001 since no major borrower was abusing of the financial system and lower rates, probably due to the ambiguous rules established upon the Maastricht Treaty. Moreover, as the economic growth was growing, public debt was gradually decreasing. A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, cit., pp. 111-112.

[287] A. Ruscakova, J. Semancikova, ‘’The European debt crisis: a brief discussion of its causes and possible solutions’’, *Procedia – Social and Behavioral Sciences*, CCXX, (2016), p. 399.

Europe jumped into a classical balance of payment crisis, a liquid crisis, caused by a sudden stop in capital lending and capital flows to the peripheral countries, followed in a second moment by a sovereign debt crisis.

The pain caused by the crisis has been acute and enormous, even though it has not been equally distributed. On the one hand, it confirmed that the Eurozone is affected by asymmetric shocks between the Core, Semi-Core and the Periphery; on the other, it revealed how different the degree of financial integration is. The Periphery suffered much more than the Core due to account and macroeconomic imbalances. Expenditures were much higher than the revenues[288]. A similar situation occurred due to a huge quantity of borrowing fostered by lower long-term interest rates in Portugal, Italy, Ireland, Greece and Spain - the so-called PIIGS countries - that led to the creation of bubbles and self-fulfilling sovereign-debt crisis[289].

Italy, Ireland, Spain, Portugal and Greece were hit by slow productivity, growth and high unemployment, rising public debts, while others, such as France and Germany, had and still have more competitive economies, high employment and growth rate[290]. Greece suffered from problems in the public sector while Ireland, Spain and Portugal were mainly hit in the private sectors, thus undergoing also increases in the assets. Surely, these outcomes fostered tensions among the countries to the extent that financial assistance was absolutely needed for overcoming the situation.

By the time, recovery seemed a mirage. Growth registered enormous falls in terms of GDP, especially in the exporting and manufacturing countries, such as Germany and Italy, while current account deficits reached dreadful levels. It was the beginning of «the Great Recession» marked by deteriorating public budgets due to recessions, packages for avoiding banks collapse, higher deficits and increasing debts[291].

No Eurozone member was immune to the systemic contagion to the extent that rescue packages for saving banks and sheltering the system were introduced.

Especially, those who enter the crisis with enormous imbalances suffered the most. The PIIGS countries were the ones who experienced terrible moments. Ireland and Spain, that were initially overwhelmed by housing and construction boom, were sooner or later devastated by the crisis.

---

[288] D. Beckworth, ‘’The Monetary Policy Origins of the Eurozone crisis’’, *Mercatus Working Paper*, Mercatus Center at George Mason University - Department of Economics, 2016, pp. 3-4.

[289] Once Eurozone was formed, a «*one-size-fits-all*» monetary policy was applied with a single interest rate without considering the level of economic development and competitiveness. As a result, long-term interest rates in the PIIGS countries decreased to the low German rate. Hence, lower interest rates allowed to borrow more in the Periphery countries, thus boosting bubbles. The monetary policy applied is absolutely incompatible to satisfy all the different economic needs. A. Ruscakova, J. Semancikova, ‘’The European debt crisis: a brief discussion of its causes and possible solutions’’, cit. pp. 401- 402.

[290] D. Kar, Asymmetric Shocks and other woes of the Eurozone, https://www.gfintegrity.org/asymmetric-shocks-and-other-woes-of-the-eurozone/, published on the 20th June 2011, consulted on the 18th October 2018.

[291] E. Marrelli, M. Signorelli, ‘’Convergence, Crisis and unemployment in Europe: The need for innovative policies’’, cit., pp.12-14.

Moreover, they experienced severe fiscal crisis, as also Portugal and Italy did. The result for the PIGS countries were long-term current account deficits, followed by slower growth and increasing unemployment[292].

The Great Recession revealed enormous weaknesses and fallacies in the European project putting the Eurozone under severe strain and pressure. An inappropriate governance structure for dealing with the crisis and also mistakes of the ECB in conducting their monetary policy clearly emerged.

The financial crisis, which turned into the worst global economic shock since the Great Depression, raised some questions over the smoothly functioning of the monetary union. The Eurozone did not only lack adjustment mechanisms but deregulation and free capital flows contributed to the creation of credit bubbles and asset prices. The enormous shortcomings of the Euro and of the currency area were also confirmed by the asymmetric shock that occurred[293].

The Eurozone was built on minimal rules with design failures that limited decision-making and concrete actions: (1) the lack of a lender of last resort for governments; (2) the elimination of automatic stabilizers in the government and (3) a centralized central bank with decentralized inefficient fiscal capacity.

Nonetheless, European countries showed an incredible, stunning and unprecedented cooperation made of rescue packages settled to avoid the collapse of the European financial market: Greece, Ireland, Portugal and Spain ‘’benefitted’’ from this financial aid[294].

By changing policy approaches and overcoming legal constraints, European countries worked together with a remarkable pragmatism for solving a crisis that was mainly caused by their misbehaviour. Nonetheless, a ‘’combo’’ of mistrust and lack of confidence among the Euro-members led to tight fiscal and monetary policies. The ECB injected a huge amount of liquidity to banks that were undergoing a stressful moment, even though it started acting only when banks were trembling and facing an insolvency-risk.

The whole process for saving countries from defaulting put an enormous strain on the European system endangering the project of European integration. Yet, a level of consultation, coordination and cooperation was advanced at the cost of high levels of technocracy and the ascendance of Germany as an ‘’imperial’’ and influential power over decisions and measures to be taken on tackling the financial crisis[295].

---

[292] K. Reinert, *An introduction to international economics. New perspectives on the world economics,* cit. , p. 344.

[293] M. Blyth, *The future of the Euro,* New York, Oxford University Press, 2015, p. 37.

[294] *Ivi*.

[295] One of the reasons for creating the EMU was the containment of German influence in the hope of France. Paradoxically, Germany has not only been able to shape European Central Bank on the Bundesbank but it has even gained a more prominent role in both the European Council and policy, in general. The Euro-crisis has, even, invigorated Germany as it is the country that has paid the largest share for the bailouts bill. P. Hall, ‘’The Euro crisis and the future of the European Integration’’ cit., p. 61

One of the main problems was that the crisis had not been treated as a structural problem but as a lesson to be given to those countries that needed to be disciplined over the respect of fiscal discipline. Extensive conditions have been imposed on very reluctant national governments on the basis that European leaders knew better how to secure growth and deficits by repaying back debts and European loans[296]. Nonetheless, the Eurozone crisis was wrongly interpreted.

European leaders, especially Germany, were initially convinced that the sovereign debt crisis had been caused exclusively by government profligacy, even though debt accumulation in the private sector was surely significant. The accumulation of both households and bank debts fuelled booms and bubbles, which inevitably collapsed thus putting into evidence the inability of banks to repay back their debts and pushing economy into a serious deflation[297].

2.2.1. From profligacy to austerity: How Greece plunged in the crisis

October 2009 was a critical moment in the human history. After the financial panic from the US spread to the Eurozone, Greek government made a stunning announcement over the true and real deficit, which amounted up to 12.7% and government debt at 127% [298].

As soon as liquidity was interrupted due to global financial and banking crisis, Greek domestic banks were unable to reinvest their deposits. By 2010, the Greek government debt was unsustainable amounting up to 146.2% of GDP, with its bonds mainly held domestically and by foreign banks, especially, French and German.

The Greek crisis acted as a propagator and detonator in the Eurozone for two reasons: (1) it revealed the violation of fiscal rules and discipline at EU level, established upon the Stability and Growth Pact and (2) it caused general panic among the investors over a possibility of sovereign default[299]. This event marked a serious drop in confidence in the European financial markets that gradually expanded in the whole Eurozone through spreads in interest rates, damaging Greece first and then Spain, Portugal, Italy and Ireland while causing also deteriorating credit default swaps (CDS) on sovereign debt[300]. It was the beginning of a ‘’doom loop’’ trapped into banking crisis and sovereign crisis revealing the susceptibility to liquidity crisis of the members of a monetary union[301].

---

[296] *Ivi*, p. 62.

[297] P. De Grauwe, ‘’Design failures in the Eurozone: can they be fixed?’’, *LEQS paper*, LVII, II (2013), pp. 11-12.

[298] Formally, Greece respected the convergence criteria, concerning deficit, which had to amount up to 3% to join the Eurozone in 2001. However, as it would have been found later, Greek government provided fake data to join Euro. In reality, the entry of Greece was too premature by the time, even though in 2006, its debt was lower that once it joined in 2001. Yet, already in July 2009, Greece warned the Eurogroup that its deficit was reaching 10%. By the time, it was thought that it was inappropriate to make a public announcement. The New York Times, Greece Admits Faking Data to Join Europe, Anthee Carassava, https://www.nytimes.com/2004/09/23/world/europe/greece-admits-faking-data-to-join-europe.html, consulted on the 21st October 2018.

[299] S. Micossi, ‘’What Future for the Euzone?’’, cit.,. p. 2.

[300] The reason why spreads were gradually increasing relies on two factors: firstly, fear or at least, risk of

By joining the EMU and gaining credibility, the Greek government had access to enormous quantity of capital flows and cheap credit, as depicted in Figure 5.1[302]. This ''easy money'' from the northern countries was directly channeled into consumption rather than employed for investments. Besides this, Greece lacked an efficient administrative structure to collect properly taxes. As a result, tax evasion and a weak fiscal condition were among the main causes of crisis-induced instability, accounting for more than half of the budget deficit in 2008[303].

Greece was running out of money from 2010, being unable to borrow at sustainable rates on the international markets. This had a double effect: one the one hand, it suffered from increasing debt to the extent that in 2010, Greece was due to repay back almost 53 billion euros, as shown in Figure 6.1; on the other, it experienced enormous public deficit to be added to already existing debt-stock. Hence, it financed the initial economic growth by means of runaways in public spending.

Solutions had to be found immediately. Greece was pushed into a bad equilibrium marked by deflation, recession, high interest rates, high budget deficit, distrust in the government's capacity to repay their debt and banking crisis being unable to response through automatic budget stabilizers[304].

---

defaulting, (the inability of a country to repay back its debt) and secondly, fears of European countries leaving the Eurozone. E. Marrelli, M. Signorelli, ''Convergence, Crisis and unemployment in Europe: The need for innovative policies'', cit., p. 15.

[301] Members of a monetary union are very vulnerable. If investors claim that some countries might have difficulties in repaying back their debt, being affected by a recession or an increase of government budget deficit, then they might decide to withdraw liquidity from the national market causing a sudden stop. Once a country is affected by a liquidity crisis, interest rates tend to increase transforming the liquidity crisis into a solvency one. A dangerous interaction between liquidity and solvency crisis is thus activated. The country might become insolvent because of investors fearing default. P. De Grauwe, ''The governance of a fragile Eurozone'', *CEPS Working Document*, CCCXLVI , V (2011), p. 5.

[302] Once Greece joined the Euro, Greece borrowing costs and debt services charges decreased substantially. Rather than opting for fiscal consolidation, as it should have done, Greece preferred to opt for tax revenue decline. Inevitably, the initial surplus evaporated while deficit expanded, accompanied by a rapid nominal income growth. The excessive borrowing starting from 2001, accompanied by debts build-up between 1980s-90s due the creation of democracy, further contributed to debt growth, amounting up to 104%. The reason why Greece found herself with high debt is only partially related to the annual capital inflow after 2001. Indeed, borrowing was added to an already high debt-stock. A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, cit., pp. 112-117.

[303] Tax evasion is one of the main sources of inequality and poverty in Greece which contributes to reduce tax progressivity, affect directly tax system and cause a loss of tax receipts. Tax evasion does not only have a direct impact on country incomes, being limited and less available, but it also affects directly decisions concerning labour, allocation of resources between consumption and savings. In particular, in Greece, tax evasion has a regressive effect implying limited growth, higher inequality and poverty. As a matter of fact, had Greece collected its VAT and taxes, social security contributions and corporate income properly, then the government would have enjoyed growth and higher GDP. M. Matsaganis, C. Leventi, M. Flevotomou, ''The crisis and tax evasion in Greece: what are the distributional implications?'', *Cesifo Forum*, XIII, II (2012), pp. 31-32.

[304] A monetary union, in time of crisis, is touched by serious complications. Firstly, bad equilibria can occur within the members of a monetary union since countries have no control over the issue of their debt being in a foreign currency. Secondly, financial markets are tremendously integrated which imply that governments in bad equilibrium can contaminate those in good equilibrium through bonds in the union. P. De Grauwe, ''The Governance of a fragile Eurozone'', cit., p. 6.

This triggered both liquidity and solvency crisis and put into evidence a further point. Considerations on a possible debt relief and debt restructuring to stabilize the country would have not obtained much popularity in Greece and among creditors as it could have affected other highly-indebted countries and made default inevitable. By the end of 2009, Greece's public debt amounted up to 296 billion Euro, with 206 billion Euro owned by foreign banks, 90 billion euros by Europeans and depositors' savings, pensions and funds invested in government bonds that Athens was unable to pay back. A systemic risk was quite evident.

The economic policy discussions on how to proceed and which measures to adopt were procrastinated and delayed on several considerations. Firstly, there were legal problems with the Lisbon Treaty due to the *no-bail-out clause* and balance of payments support[305]. This no-bail-out clause did not specify any institution responsible for supervising cross-border fiscal insurance suggesting that debt restructuring would have been feasible. Secondly, economic problems were raised by moral hazard. Hence, financial instability was further fostered as countries and institutions did not know how to proceed in the lack of any provision for crisis management in the Eurozone. Thus, procedures had to be created. Being the Commission not endowed with an equipment over financial and economic crisis, the ECB would have played a more significant role[306].

Having Greece misbehaved by overspending irresponsibly, resulting in high debt levels and explosive deficits, insolvency came as a result of their actions and own mistakes. Debt relief was automatically ruled out, even though no provision in the Treaties denies this procedure nor constitutes a incompatibility in the system. However, in the absence of any ''guideline'' on how to proceed in case of crisis, financial assistance was preferred even though it was thought that moral hazard would have been fostered. A tactic based on ''wait and see'' was adopted.

In May 2010, a package (amounting up to 100 billion Euro with tough rates and quarterly instalments over three years) for ''rescuing'' Greece was agreed. Yet, it was predictable that sooner or later, a repayment shock would have occurred. The negotiations can be enormously criticized for how they were conducted and, especially, for who was involved for containing costs and losses of debt relief. The European Commission, the IMF and the ECB – the Troika - were the institutions entitled with

[305] Together with the financial crisis, the Lisbon Treaty came into force on the 1st December 2009 reinforcing and stressing that fiscal discipline and debt were a national responsibility. Initially, bailout's denial on behalf of Germany was influenced by art. 125 TFEU while debt mutualisation, which could have allowed to share the burden of Greece debt, was denied on the basis of fiscal responsibility. A. Tooze, *Crashed: Crashed: How a decade of a financial crisis changed the world,* cit., pp. 332-339. Art. 123 TFEU and art. 125 TFEU were introduced with the aim of avoiding excessive debt and deficit by preventing moral hazard of over-spending. Moreover, both articles aim at protecting prudent European taxpayers by introducing a no-bail-out clause, which ensured the fact that it would have been a national responsibility to repay back national debt and impeding risk due to inadequate fiscal policies. These articles together aimed at promoting and encouraging both fiscal stability and prudent fiscal behaviour. Art. 143 TFEU was one of the binding articles that was preventing EU policy-makers and leaders to help Greece. Balance of payments support could be attributed only to those countries that were not members of the Eurozone.

[306] C. Wyplosz, ''The six flaws of Eurozone'', cit., p. 597.

providing financial assistance to Greece. An emergency loan and adjustment program to repay-back debt with loans were granted while debt restructuring was initially ruled out[307].

The ECB's involvement in these negotiations can be highly debated. Nonetheless, the monetary authority is also the only body entitled to defend European interests concerning banking and financial system. Greek default could have directly impacted the Eurozone. Even though its involvement in structural reforms is surely inappropriate and worth of critics, ECB should also be concerned with what happens in terms of credit creation in the single Eurozone countries.

By involving the IMF, the credibility, prestige and autonomy of Europe was enormously compromised and put into question since they were asking financial assistance and support to an external body to the extent that even the ECB opposed[308]. Yet, Greece needed not only debt restructuring despite the immediate and devastating implications in Greek banking system and feasible broader spillover effects but also, fiscal and economic growth. Meanwhile, ECB proceeded by downgrading Greek government bonds, which proved vital for supporting Greek society and government.

Two bail-out loans were provided for financing public debt on the assumption that they would have adopted stringent measures for reducing spending, increasing taxes and applying structural reforms contributing to the consolidation of the financial situation[309]. A very large number of reforms and *draconian austerity* - in the banking, social and political system - were asked to Greece to inject a healthy dose of fiscal discipline and restructure Greek public sectors and economy. Yet, this simply worsened the internal situation as the budget adjustment devastated Greek economy while market was exposed to further market pressure to the extent that already by mid-2010, Greece was expected to repay around 8.9 billion euros[310].

---

[307] After a long denial, Greece was finally given a debt relief in 2011 provided that, under Germany's pressure, banks, lobby groups and private sectors supported assistance. German initial reluctance over debt restructuring was due to several reasons: (1) the need of an aggressive bank recapitalization; (2) the creation of a fund for avoiding further destabilization; (3) ECB's action for stabilizing bond markets and injecting liquidity in the banking system and (4) the need of bypassing art. 125 TFEU that barred countries from buying debts. A. Tooze, *Crashed: Crashed: How a decade of a financial crisis changed the world,* cit., p. 341.

[308] D. Hodson, ''Policy Making under Economic and Monetary Union: Crisis, Change and Continuity'', cit., pp. 175-177.

[309] Before taking this decision, the European Union had actually to face a challenging choice. One the one hand, Eurozone could opt for debt-restructuring, causing Greece default on its debt, followed by financial support for enhancing the shift in the direction of surplus. This solution was highly supported by some economists who claim that restructuring is the best solution for debt crisis. On the other, they could lend funds and loans to Greece for repaying back their debts in exchange of structural reforms to promote Greece's fiscal stability. The second option occurred but adjustment was controversial. P. Hall, ''The Euro crisis and the future of the European Integration'', cit., p. 56.

[310] Austerity badly hit the public sector by means of severe cuts. Contracts were not renewed, pension age was raised and taxes were risen. Hence, an economy that was already under pressure suffered even more with decreasing standards of living. A. Tooze, *Crashed: Crashed: How a decade of a financial crisis changed the world,* cit., p. 347.

By 2012, it was quite evident that financial assistance was not working, austerity measures were failing in bringing growth and recovery and finally, debt was reaching tremendous levels[311]. By lending more to Greece, the country got even more indebted because bailout-loans were used for repaying back debts rather than producing investments. The main problem was related to fiscal measures. The ones that were introduced were not focused on relaunching Greek economy by investing in human capital, infrastructures and innovation. On the contrary, they only paid attention on how to roll over the existing debt[312]. Hence, in the need of more financial aid for restoring confidence and improving competitiveness, a further loan and full-scale bailout of Greek banks were granted to Greece while a debt relief - being inevitable and inescapable - occurred from 2012.

At the end of October 2011, it was indeed decided to reduce Greek debt below 120% and to ensure further financial assistance through the European Financial Stability Facility (EFSF) and bank recapitalization. Even though debt reduction and recapitalization were finally acknowledged as the key for solving the crisis, these measures had been unsuccessful for relaunching the economy[313].

Whether structural reforms were the right medicines is a matter of debate. Greek banks lost most of their bonds (held now both by the ECB and their private investors). Furthermore, Greece was punished for its misbehaviour through enormous spending cuts for reducing high deficit and increasing debt while budgetary austerity was harshly applied fostering both recession and losing competitiveness. Privatization applied under severe fiscal distress simply leads to higher unemployment, worse conditions and dependency on foreign capital.

For the first time, an independent apolitical institution as the ECB took part in political negotiations and in the Troika, raising a real conflict of interests. The ECB was involved in concerns beyond monetary and financial responsibilities, negotiating directly with the Greek government over wages, pensions, reforms, overcoming its independence. Basically, the ECB acquired a direct interest in

---

[311] Greece received a first loan of 110 billion euros in May 2010, of which 30 billion were provided by the IMF and the remaining 80 billion by the Euro-members. Greece would have received loans provided that they applied enough policies for reducing government deficits from more than 15% to almost 3%; budget cuts, tax increases and both wage and pension freezing. G. Karamichailidou, D. Margaritis, D. Mayes, ‘’Asymmetry, Austerity and Anxiety: The approach to the Greek Debt Crisis’’ in C. Floros, I. Chatziantonious (edited by), *The Greek Debt Crisis: In Quest of Growth in Times of Austerity*, Cham, Palgrave Mcmillan, 2017, pp. 42-43.

[312] *Ivi*, p. 42.

[313] By 2012, European leaders became aware of the fact that Greek debt was unsustainable. Thus, they decided to opt for the Private Sector Involvement (PSI), which led to a cut of 53.3% of value imposed on private bondholders. When it was understood that a similar measure was not bringing any further improvement, it was decided to opt for a further reduction of the Greek debt by 49% through interest rates, fees reduction and extended maturity over loan. The main problem in achieving debt sustainability in Greece was its collapsing GDP and its elevated debt level due its economy contraction. Hence, by April 2012, 199 billion euros in Greek government bonds were converted in exchange for almost 30 billion euros in short-term cash and 62 billion euros in long-term bonds. Last but not least, the net value of Greek claims was further reduced. Greece received further funding by the Troika while Greek bonds, held by the ECB, were not subject to debt restructuring. Greece’s public debt was reduced enormously with most of the debt held by EFSF, ESM, ECB and IMF. A.Tooze, *Crashed: How a decade of a financial crisis changed the world*, cit., pp. 435-436.

programming structural reforms in Greece. This is also suggested by the lack of interest in debt restructuring, at the beginning, since it would have implied a major cost in the ECB's balance sheet[314]. The situation changed with the arrival of Mario Draghi and a new wave for both Greece and the ECB's policy. Under the new Presidency, it was decided to inject further liquidity to Greece and to soften the option of debt restructuring. Draghi was sure that it would have not incurred in a destabilizing effect for the European financial system, showing a new constructive approach.

Surely, the reason why Greece has been saved rather than opting for its default has been highly debated and controversial. One of the main explanations relied on fears of a systemic contagion within the Eurozone as the Greek default would have implied enormous and too serious consequences for the banking system and for other economies, such as Italy, considered «too big to be rescued». Moreover, efforts for saving Greece and preventing the country from leaving the Eurozone are related to the impossibility of abandoning the monetary union and the fatal consequences that it might imply for the stability of Euro, such as speculative attacks.

The Greek economy suffered enormously as the structural reforms applied hindered its capacity of growing economically. The levels of austerity measures were so high that they basically compromised any possibility for Greece to recover, undermining even market confidence in the country. Whether structural reforms provide benefits in the long-term is arguable as results tend to reverse only in the long-term[315].

Focusing only on the fiscal problem was a mistake even though «*the coordinated market economies*», such as Germany, considered it a priority. Nonetheless, insisting that fiscal austerity measures are the basis and the stimulus for economic growth is a pure mirage. Rather, they have a contractionary effect on the economy, at least in the short-run. A large amount of the population is still unemployed as depicted in Figure 7.1, with a very low level of productivity and attractiveness for investments and

[314] The ECB's statute relies on price stability and independence. Nonetheless, the ECB started pressuring Greek government for adopting structural painful reforms that blocked a feasible economic expansion in Greece. B. Eichengreen, ''The European Central Bank: from problem to solution'' in *The Search for Europe: Contrasting Approaches*, BBVA, Madrid, 2016, p. 11.

[315] The economic recession that Greece underwent had no precedent. Once the bail-out was approved, Greece suffered from a crash in size of growth, with a fall of 6.9% in 2011, followed by -5.5% in 2012. GDP-loss amounted up to 17.4% by 2012. On the contrary, from the fiscal point of view, Greece reported another scenario: revenues increased from 38% in 2009 to 41% in 2011 while expenditures fell from 53.8% of GDP in 2009 to 50.3% in 2011. Deficit reduction amounting up to 5% of GDP was already achieved in 2010 at the cost of high social terms. M. Matsaganis, C. Leventi, M. Flevotomou, ''The crisis and tax evasion in Greece: what are the distributional implications?'', cit., pp. 31-32. By conforming with the restrictive measures imposed on Greece, the possibility of growing economically was basically impossible. On the one hand, Greece was asked to reduced its fiscal deficit from 15% to 3% within three years for obtaining the bail-out fund; on the other, more than 90% of the funds were used for repaying back interests leaving no room for aggregate demand and growth. This resulted in low GDP growth and an increasing debt. P. Hall, ''The Euro crisis and the future of the European Integration'', cit., p. 58.

investors[316]. Recession worsened, debt accumulated, growth slowed down[317]. The main problem was related to the decision of applying a model based on consumption rather than investment.

A debt restructuring as first approach would have been much more profitable for Greece resulting in less cost and suffering for the Greek population. Nonetheless, it would have not been convenient for Europe as it would have required higher adjustment costs and less structural reforms[318].

[316] Austerity measures are an ambiguous approach. Cutting expenditures and raising taxes have a negative effect on a falling GDP and constant increases in debt levels. Therefore, further cuts are thus asked to bring down the accumulation of debt. G. Karamichailidou, D. Margaritis, D. Mayes, ''Asymmetry, Austerity and Anxiety: The approach to the Greek Debt Crisis'', cit., p. 38.

[317] Greek government debt increased over the time, shifting from 126% in 2009 to 172% in 2011, dropping to 159% in 2012 and then increasing up to 177% in 2013, until 180% in 2016. Greek fiscal position is much worse now than at the beginning of the financial crisis. Similarly, GDP contracted enormously while unemployment exploded. Trading economics, Greece Government Debt to GDP, https://tradingeconomics.com/greece/government-debt-to-gdp, consulted on the 20th October 2018.

[318] P. Hall, ''The Euro crisis and the future of the European Integration'' cit., p. 60.

Figure 5.1. Greece Credit Expansion and Capital Flows 2001-2018[319]

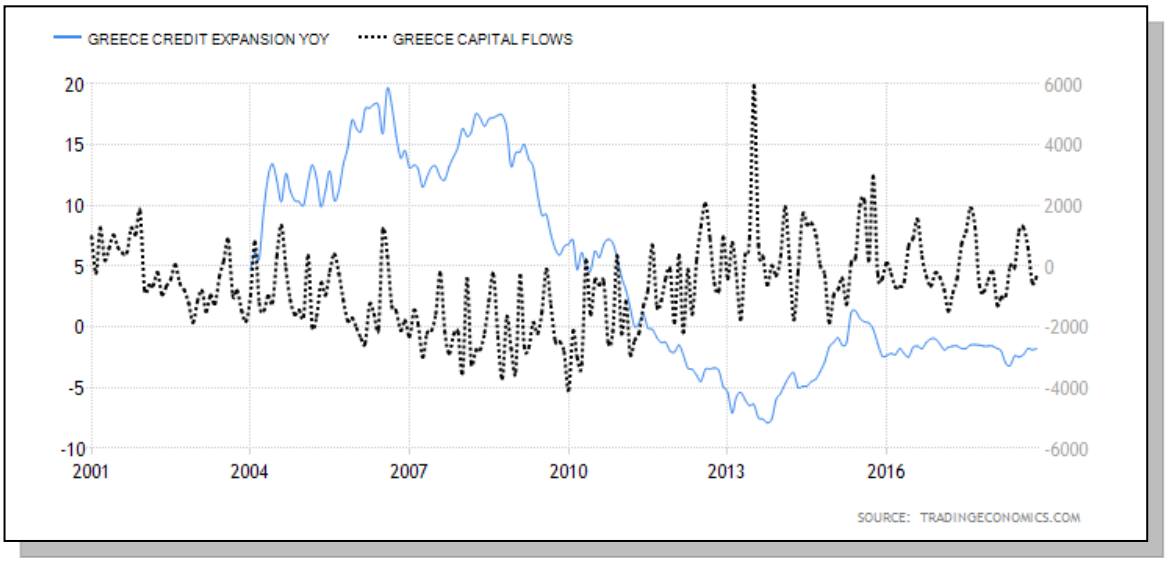
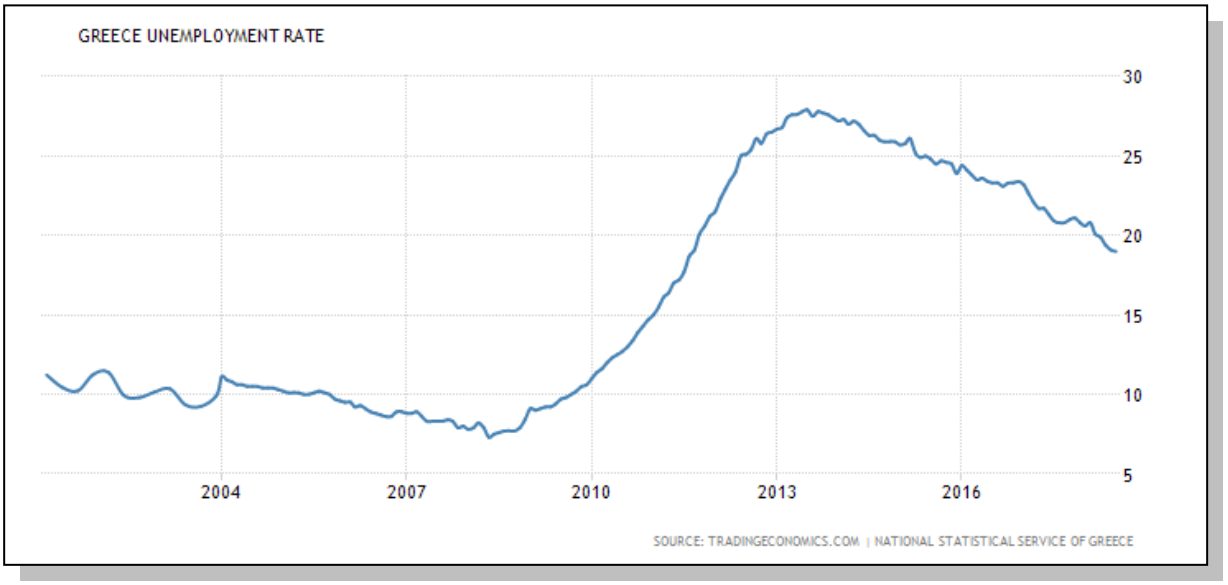


Figure 6.1. Greece Government debt to GDP 2001-2018[320]

[319] Trading Economics, Greece Capital Flows 2000-2018, https://tradingeconomics.com/greece/capital-flows, consulted on the 17th October 2018.

[320] Trading Economics, Greece Government Debt to GDP 2001-2018, https://tradingeconomics.com/greece/government-debt-to-gdp, consulted on the 18th October 2018.

Figure 7.1 Greek Unemployment Rate 2001-2018[321]



[321] Trading Economics, Growth Unemployment Rate 2001-2018, https://tradingeconomics.com/greece/unemployment-rate, consulted on the 18th October 2018.

2.2.2. From ‘’booming bubbles’’ to financial collapse: Comparing Ireland and Spain

The financial crisis suffered from the EMU between 2008-2012 showed an unprecedented action in the European decision-making. Europe’s response was initially characterized by lack of initiative and coordination. On the contrary, in a second phase, bail-out measures and programs were provided with the primary aim of avoiding the Eurozone collapse and default that would otherwise affect all countries.

Greece is not the unique country who ‘’benefitted’’ from this ‘’pill’’ in exchange of severe and stringent conditions in terms of *austerity* for limiting fiscal deficits.

What happened in Greece did not stay in Greece as the risk of contagion was serious. Portugal, Spain and Ireland were contaminated by Greece when credibility in the financial markets started trembling and the spread between the interest rates on German bonds and other European countries exploded in the Eurozone. Inevitably, they were driven into a severe depression.

Already in September 2008, it was known that Ireland – an offshore banking hub - held more than 400 billion Euro of banks liabilities that might have requested a debt restructuring and a private sector involvement (PSI). Yet, it was only in March 2010 that the situation became more dramatic as Irish deficit, amounting at 32%, was even worse than Greece due to the costly Irish banking recapitalization. The banking system was pulling down the sovereign[322].

Like Ireland, also Spain had experienced one of the most extreme housing bubbles with devastating consequences, once it exploded. Unemployment rate shot up with a catastrophic increase in the youth, amounting up to 55% by the Summer 2012.The problem was that the Spanish economy was quite big in comparison to Ireland and Greece.

Both Ireland and Spain suffered enormous public deficits and high private debt, which requested a treatment similar to the Greek one[323]. Yet, these countries managed to overcome the situation through economic adjustments due different in internal structures.

All these countries had in common the ‘’easy credit’’ coming from both France and Germany, where capital flows were invested in the public and private sectors. Nonetheless, there exists one crucial difference. Public spending in Spain and Ireland is not the underlying reason for large deficits. Both experienced significant surpluses thanks to foreign capital flows that fed housing boom and price inflation[324]. This boom resulted in increasing growth and debt-to-GDP rate and excessive credit

---

[322] A. Tooze, *Crashed: Crashed: How a decade of a financial crisis changed the world*, cit., p. 347.

[323] Like Greece, in order to receive financial assistance, Ireland and Spain had to implement both austerity and structural measures, ranging from cuts in public expenditures, higher taxes to reforms affecting social welfare system, pension and labour market. E. Marrelli, M. Signorelli, ‘’Convergence, Crisis and unemployment in Europe: The need for innovative policies’’, cit., p. 15.

[324] Spain never really suffered from government deficits nor government debt over a period between 1998-2007. Deficit was, indeed, kept around 3% while debt stood below 40% in 2008. Similarly, Ireland did not suffer from debt accumulation, in 2009, being at 42%. The situation changed drastically once the bubbles exploded. G. Karamichailidou, D. Margaritis, D. Mayes, ‘’Asymmetry, Austerity and Anxiety: The approach to the Greek Debt Crisis’’, cit., pp. 48-53.

expansion and external imbalances[325]. These factors led to massive real housing bubbles, as depicted in Figure 8.1.

As a consequence, as soon as capital flows suddenly stopped, initial booms turned into busts. Public debt and deficit increased enormously due to bank losses, even though the Irish government reacted by guaranteeing both deposits and debts to preserve stability. Furthermore, once economic boom and private credit growth stopped, both Spain and Ireland had to bail out the private sectors.

The crises of Spain and Ireland were caused by private debt accumulation. It became public once they had to proceed through rescue packages and operations. Hence, their respective economies precipitated into a severe recession and accumulation of public debt. As a consequence, a sovereign debt crisis emerged for three main reasons: (1) debt accumulation from both private and public actors; (2) the quantity of capital borrowed from abroad; (3) the duration of the money injection [326]. Yet, the debt problem was even exacerbated due to the Eurozone's structure which was further aggravated by distrust in the financial market pushing towards default-risk and a fairly integrated bank-based financial system easily exposing countries to financial crisis.

The crisis has gotten worsen because of the strong nexus between banks and sovereign debt. If the former holds public debt, the latter is the ultimate guarantor of banks. Hence, the Eurozone governance structure was further weakening Ireland and Spain[327].

The nature of this crisis was initially misdiagnosed. Ireland and Spain suffered from a liquidity crisis due to investors' loss of confidence. They both suffered from housing and construction bubbles, which showed sign of deflation from 2007, compromising the stability of banks being mainly involved in these sectors. As a result, when the construction sector was hit, also the banking system suffered.

The whole situation was further aggravated by the fact that by selling Irish and Spanish government bonds and reinvesting them in safer countries like Germany, these countries were suddenly deprived of liquidity flows that simply made impossible to repay back their debt at a reasonable interest rate. To worsen, when Spain and Ireland started bailing out their private sectors - both housing and construction - they were basically saving creditors from the Core countries[328].

The Eurozone is not the unique area where banks held public bonds. The main problem is related to the fact that governments are deprived of a lender of last resort function and automatic stabilizers in the government budget. Furthermore, governments cannot rely on national central banks for printing

[325] One of the main factors that contributed to the economic boom in Ireland was its favourable tax system from which foreign corporations could benefit by injecting billions of dollars with lower taxes. Proud of this approach, Ireland considered itself as branch of the American free market. A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, cit., pp. 120-121.

[326] D. Beckworth, ''The Monetary Policy Origins of the Eurozone crisis'', cit., pp. 12-13.

[327] D. Gross, ''The Eurozone Crisis and foreign debt'' in R. Baldwin, F. Giavazzi, (edited by*), The Eurozone Crisis: A consensus view of the causes and a few possible remedies*, London, CEPR Press, 2015, pp. 123-125.

[328] D. Beckworth, ''The Monetary Policy Origins of the Eurozone crisis'', cit., p. 13.

money and financing economy whenever a problem occurs. Thus, a similar situation lead countries into bad equilibria and banking crisis[329].

Since government bond prices were collapsing, also bank balance sheets were suffering being exposed to credit deterioration[330]. Doubts over an insolvent government fostered considerations over banks insolvency. As a result, this triggering phenomenon requested the direct intervention of the European institutions and pushed the national governments into austerity programs, even though Spain had already started on a voluntarily basis[331]. Nonetheless, as in Greece, austerity packages intensified the crisis [332].

Being the Spanish economy too big not to bail-out and to default, it had to be saved. Had it collapsed, the EMU could have come to an end. As a result, the ECB intervened by means of the Securities Market Program (SMP), allowing a cooling of Spanish spreads, while demanding, in some secret ECB letters, huge cuts to government spending, increased taxation and lastly, changes to labour market policy for reducing unemployment while ensuring growth[333]. Furthermore, the heads of state showed

---

[329] As soon as the Eurozone was established, a stabilizing factor guaranteed by the lender of last resort function of the central bank was taken away from member countries. This implies that countries had to issue national debt without having control on the currency. Initially, they could rely on the fact that they would have been always able to pay bondholders while liquidity would have always financed their debt, since they were issuing their debt in their own currency. Now, they have no control at all. P. De Grauwe, ‘’Design failures in the Eurozone: can they be fixed?, cit., p. 9.

[330] Once the housing bubble exploded, the Spanish social democratic government succeeded in managing mortgage banks involved by activating a bailout fund. Yet, by 2010, bank balance sheets amounted up to 30% of GDP. In November 2011, the crisis reached its height. As a matter of fact, new provisions were activated but they were not sufficient for calming down the markets to the extent that ECB had to inject a huge liquidity in Spanish banks by Spring 2012 to avoid a financial collapse. Indeed, in 2012, Spanish economy was struggling to cut its budget deficit from 11.2% to 5.4% of its GDP. Still, maintaining liquidity was not sufficient for restoring solvency. Spanish banks were prone to declare bankruptcy being in the need of an immediate recapitalization. To worsen the scenario, Spanish economy was already depressed and with Spanish banks’ announcement, yields on public debt exploded up to 6% thus leading to an increasing debt service cost. Inevitably, European bond market yields augmented in all the Eurozone, especially in the Periphery. Hence, both European banks and government were not only involved in an intricate bank-sovereign doom loop but they also need to roll over and refinance their debt. A. Tooze, *Crashed: How a decade of a financial crisis changed the world*, cit., pp.441-442.

[331] Spain started applying austerity measures since 2008 in an attempt to reduce deficit while regaining trust and confidence in the international markets to decrease interest rates. Before doing it, Spanish government had guaranteed a fund amounting up to 71 billion euros to the banking system. G. Karamichailidou, D. Margaritis, D. Mayes, ‘’Asymmetry, Austerity and Anxiety: The approach to the Greek Debt Crisis’’, cit., p. 53.

[332] The reasons why austerity intensified the crisis is related to the fact that while restrictive fiscal policies were imposed in exchange of debt relief and bailout, expansionary fiscal policy was not compensated in the Core countries thus creating a detrimental and vicious circle. D. Beckworth, ‘’The Monetary Policy Origins of the Eurozone crisis’’, cit., p. 15.

[333] The Securities Market Programme (SMP) was introduced in May 2010 with the aim of ensuring liquidity in the malfunctioning debt securities markets and restoring the functioning of the monetary policy transmission mechanism. This mechanism was introduced due the inability of certain financial markets to absorb transactions without having a direct impact on prices. The SMP intended to foster financial market liquidity. Additionally, this new mechanism assured that the Euro-countries could have purchased debt securities from the European countries thus promoting better and more appropriate financial market conditions. ECB,

an unprecedented level of cooperation by introducing two ad hoc stability mechanisms: the European Financial Stability Facility (EFSF), created as a temporarily mechanism, then transformed into a permanent rescue fund under the European Stability Mechanism (ESM) that provides loans to countries in difficulties and financial assistance by involving the private sector through a *bail-in*[334].

As a matter of fact, in November 2010, Ireland received 85 billion euros, followed by Spain, in May 2011, with 41 billion euros to recapitalize and restructure their banks. Debt burden started increasing, as depicted in Figure 9.1., while the vicious circle between sovereign and banking debt was impossible to break[335].

Particularly emblematic is the case of Ireland for two reasons. Firstly, it was prevented from providing names of the bondholders of its banks and passed losses to them in an attempt to restore confidence and trust on the European financial markets. Thus, the Irish taxpayers had to bear the costs. Secondly, high interest rates were applied, having a very unfortunate effect: difficulties in reducing budget deficit and debt accumulation[336]. All these efforts were done in an attempt to recapitalize national banks. Otherwise, their collapse would have resulted in a further financial global shock.

Despite the introduction of similar mechanisms, the situation did not show any sign of improvement. Especially, the EFSF was suggesting a feasible risk of default for Eurozone countries. In the end, even though financial support saved the single currency, financial markets were still mistrusting the control over a sovereign debt crisis, thus requiring an enormous intervention of ECB in saving Eurozone through the Outright Monetary Transactions (OMT)[337].

Monthly Bulletin June 2010, https://www.ecb.europa.eu/pub/pdf/other/mb201006_focus01.en.pdf?19bf37eb4c6d5fac0955948ca5af3aa0, consulted on the 21st October 2018.

[334] The European Financial Stability Facility (EFSF) was created, in June 2010, on the basis of an inter-governmental treaty, as a temporary resolution mechanism on a cooperation among the Eurozone members states for providing assistance to Ireland, Portugal and Greece. Eurozone countries gave capital on a country-by-country basis without taking any commitment for European sovereign debt. The EFSF guaranteed cooperation between the European institutions, especially the Commission, which was entitled to grant financial aid to those Eurozone-countries in trouble. The EFSF provided help by issuing EFSF bonds and applied a specific funding strategy, relying on several instruments and maturities, for ensuring efficient funding and market access. Basically, the EFSF acted as a firewall that was allowed to borrow even against the capital invested in it. Even though it does not provide any additional financial assistance, it continues to operate by receiving loan repayments, extending EFSF bonds since the maturity of loans provided is longer than the one of EFSF bonds. European Stability Mechanism (ESM), Before the ESM: EFSF – the temporary fiscal drop, https://www.esm.europa.eu/efsf-overview, consulted on the 20th October 2018.

[335] D. Beckworth, ‘’The Monetary Policy Origins of the Eurozone crisis’’, cit., p. 10

[336] P. Hall, ‘’The Euro crisis and the future of the European Integration’’, cit., p. 57.

[337] By adopting the OMT, the ECB demonstrated its serious commitment to support the financial market and system, even though it did not find the causes of sovereign debt crisis nor a solution over the concerns about the continue instability of the national governments. That said, lending was given to banks so that governments would have borne the costs of the bank bailouts. The initial lack of this mechanism put into enormous danger Irish and Spanish economies and financial institutions raising a default-risk. D. Hodson, ‘’Policy Making under Economic and Monetary Union: Crisis, Change and Continuity’’, cit., p. 178.

It was only by the end of 2012 that the scenario got better by decreasing possible level of systemic risk.

The austerity policies and pro-cyclical budgetary policies applied as a condition for obtaining finance had a controversial and negative effect: recession. One the one hand, Spain, Ireland and also Greece were obliged to apply contractionary policies, which were not compensated by expansionary fiscal policy in the Core countries. Inevitably, more divergence appeared in the Eurozone. Economic activity slowed down, taxes increased and growth collapsed even more. This even fostered financial panic and sovereign debt crisis to the extent that Spain, Portugal and Ireland even intensified austerity programs. A better diagnosis of the crisis would have avoided certain measures[338].

In contrast to the Greek scenario, affected by enormous rigidity, Ireland was much more structurally flexible in the labour market in terms of wages and mobility. These factors together enhanced an increasing recovery, facilitated by being an English-speaker country, enriched with high-skilled workers and a favorable tax treatment, able to attract investors and investments. Moreover, being wages lower than before, a large portion of the population simply migrated. On the contrary, Spain started growing but at levels too low to talk about success in the country[339]. This can be observed in Figure 10.1. and Figure 11.1.

Even though the financial support in time of crisis has been a good remedy and a proof of a cooperative and integrative Europe, the lower levels of growth, higher public deficits and government debts have been the result of the wrong ‘’pills’’ adopted for recovering from the crisis. Especially, the Periphery suffered from economic contraction[340]. By introducing restrictive conditions, stability in the Eurozone is still trembling.

Austerity contributed to the double-dip recession between 2010-2011 in which the European economy plunged. Periphery countries – the Debtor - were asked to decrease their spending through internal devaluation while the Core - the Creditor – kept their spending for balancing their budget through internal revaluation. Deflation is, indeed, emerged since 2012 as a result of these adjustments to the imbalances[341].

The ‘'cocktail’’ of these measures added an additional aggravating factor proving that these expansionary measures, followed by enormous sacrifices, have not delivered the promises expected.

---

[338] P. De Grauwe, ‘’Design failures in the Eurozone: can they be fixed?, cit., p. 10.

[339] Ireland was much more flexible than Greece also thanks to structural reforms and changes that occurred through a series of agreements, in the 1980s, between government, unions, employers, government reforms and investments over wage-restraints that nonetheless helped promote further competitiveness. Softer regulation and favourable tax treatment allowed Ireland to achieve a better adjustment. Thus, Ireland has a greater structural flexibility than Greece. G. Karamichailidou, D. Margaritis, D. Mayes, ‘’Asymmetry, Austerity and Anxiety: The approach to the Greek Debt Crisis’’, cit., pp. 50-51. Spanish economy is growing extremely slow, at 0.6% per year. Still, the economy is registering a high unemployment rate, stalled at 15.8% while youth unemployment rate is stuck at 33%. Trading economics, Spain Economic Indicators, https://tradingeconomics.com/spain/indicators, consulted on the 20th October 2018.

[340] D. Beckworth, ‘’The Monetary Policy Origins of the Eurozone Crisis’’, cit., p. 7.

[341] P. De Grauwe, ‘’Design Failures in the Eurozone: Can they be fixed?’’, p. 19.

On the contrary, the PIIGS countries suffered from losses in terms of output and employment in the debtor countries[342].

The already dismal economic performance of the Eurozone has been further aggravated by the inability of stabilizing government debt ratio in the debtor countries in opposition to the creditors that have successfully succeeded. Moreover, it has also brought to social and political rejection and a scarce acceptability and support of the Eurozone.

The financial crisis revealed that the monetary union is something more than sharing a single currency. By the time of tumultuous years, fiscal rules, economic and structural reforms were introduced. In reality, what was needed was a more substantial financial effort for two reasons: (1) Providing more appropriate adjustment programs and (2) Convincing the tumultuous financial market that the Eurozone countries would not default.

A collective mechanism for mutual support and control could have been useful. On the contrary, massive austerity policies were introduced for improving confidence in the financial markets and punishing those countries that did not respect the fiscal policy imposed at a national level. Nevertheless, a similar approach is not only unable to restore budgetary balance and recovery but is also self-defeating[343].

What started as a liquidity crisis turned into a solvency one as a result of pro-cyclical fiscal policies that pushed the countries into further deflation. The EU policies were inadequate stressing that a collective mechanism is needed for responding to problems and for providing incentives not to incur into further profligacy. Since a monetary union creates collective problems due to financial integration, a collective solution is needed[344].

The Eurozone has, indeed, jumped into a sort of dysfunctional system where some countries have suffered more than others revealing a real discontent that led even to considerations and hypotheses about leaving Eurozone. However, a similar plan seems to be impossible and rather costly. Moreover, the crisis has put into evidence that the monetary policy affects the country in a very different way due to dissimilar economic and financial situations.

ECB's monetary policy and its policy errors caused further accumulation of debt, resulting in severe sovereign debt crisis, thus empowering austerity measures. This also confirms that the application of

---

[342] S. Micossi, ''What future for the Eurozone?'', cit., p.3.

[343] The efficacy of austerity is surrounded by a very intense debate. On the one hand, supporters of these measures, in line with the Monetarist view, claim that restrictive fiscal policies are not a direct cause of falls in income and production. Rather, they are convinced that fiscal adjustments lead to an increasing consumption. Expansionary austerity relies, indeed, on the idea that spending should be accompanied by an appropriate ''policies package'', based on easy money, liberalization and structural reforms, avoiding in this way a direct impact on growth. By establishing higher credibility, creditworthiness and a better sustainability of public debt, private investors feel more confident and more attracted. On the other hand, the opponents that coincide with the Keynesian view, claim that imposing austerity imply losses in terms of output, GDP and increase in debt due to higher taxation and cuts in public expenditures. E. Marelli, M. Signorelli, ''Convergence, Crisis and Unemployment in Europe: The need for innovative policies'', cit., pp. 25-27.

[344] *Ivi*, p. 17.

«*one-size-fits-all*» in a suboptimal area is only detrimental[345]. Surely, the Eurozone survived the crisis thanks to the phase of state building that emerged from the crisis. Yet, both economic and political cost was extreme as the governments of Greece, Spain and Ireland underwent enormous changes due to also the Troika's intervention. The ECB succeeded in calming down the markets but the Eurozone economy is still not fully recovering.

[345] During the crisis, the ECB applied a tightened monetary policy based on raising interest rates thus fostering the sovereign debt crisis. In other words, it seems that public debt accumulation has been a direct consequence of this approach. Indeed, at the beginning of the crisis, the ECB decided not to lower interest rate while keeping them extremely high (at 4%). Beckworth, ''The Monetary Policy Origins of the Eurozone crisis'', pp. 17-18.

Figure 8.1. A comparison between Spanish and Irish House and Residential Prices 1999-2018[346]

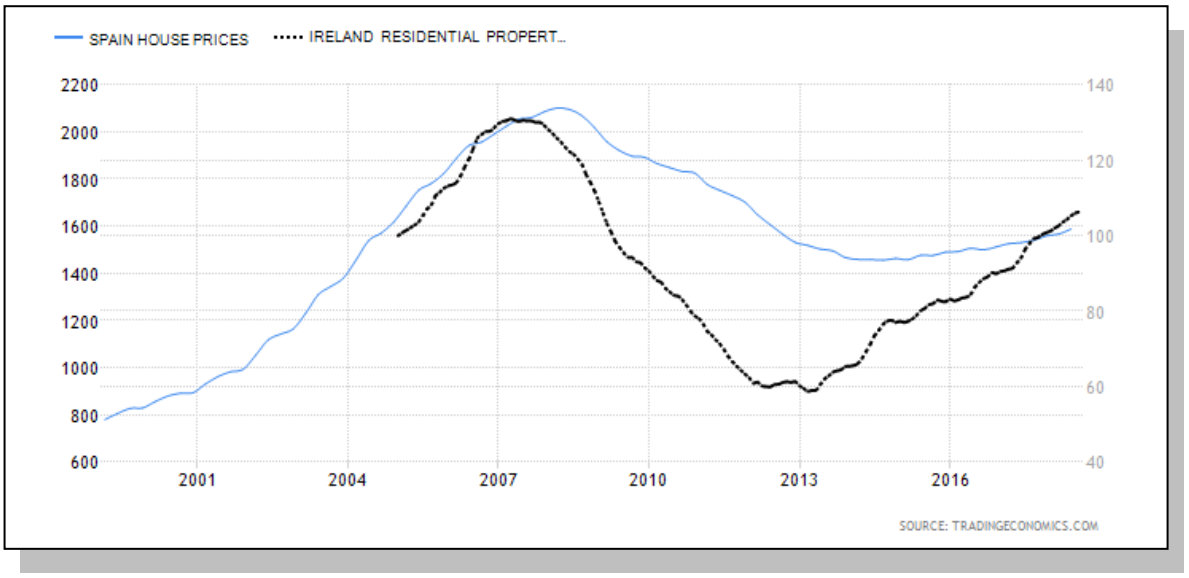
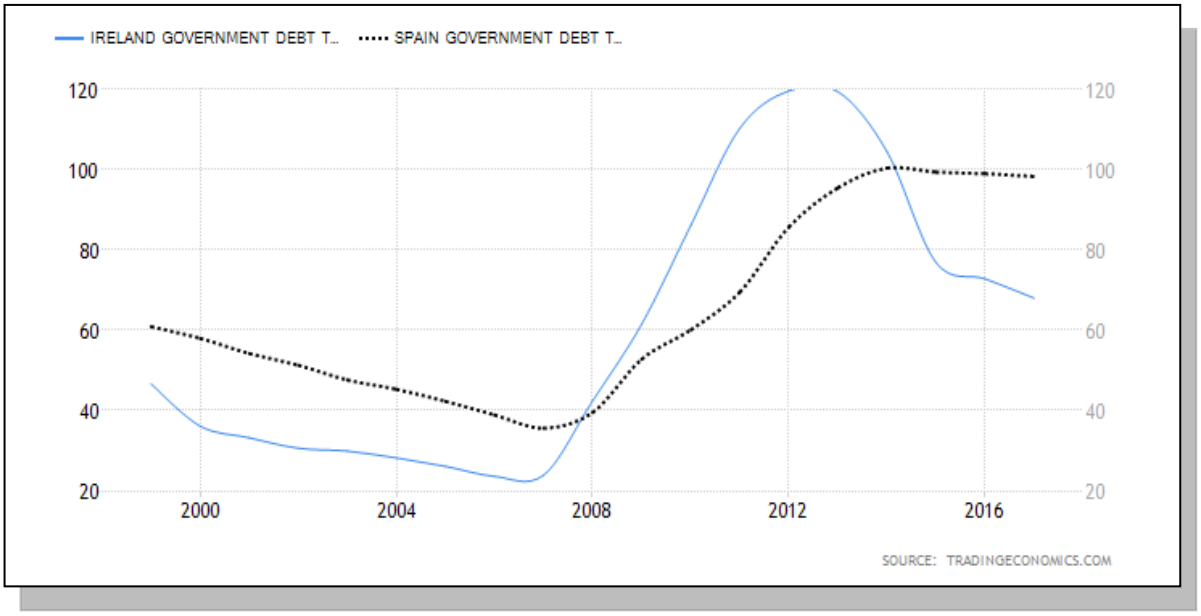


Figure 9.1. **A comparison between Spanish and Irish Government Debt to GDP 1999-2018**[347]



[346] Trading Economics, A comparison between Spanish and Irish House Prices, https://tradingeconomics.com/spain/housing-index, consulted on the 18th October 2018.

[347] Trading Economics, A comparison between Spanish and Irish Government Debt to GDP, https://tradingeconomics.com/ireland/government-debt-to-gdp, consulted on the 2nd February 2018.

Figure 10.1. A comparison between Spanish and Irish Unemployment Rate[348]

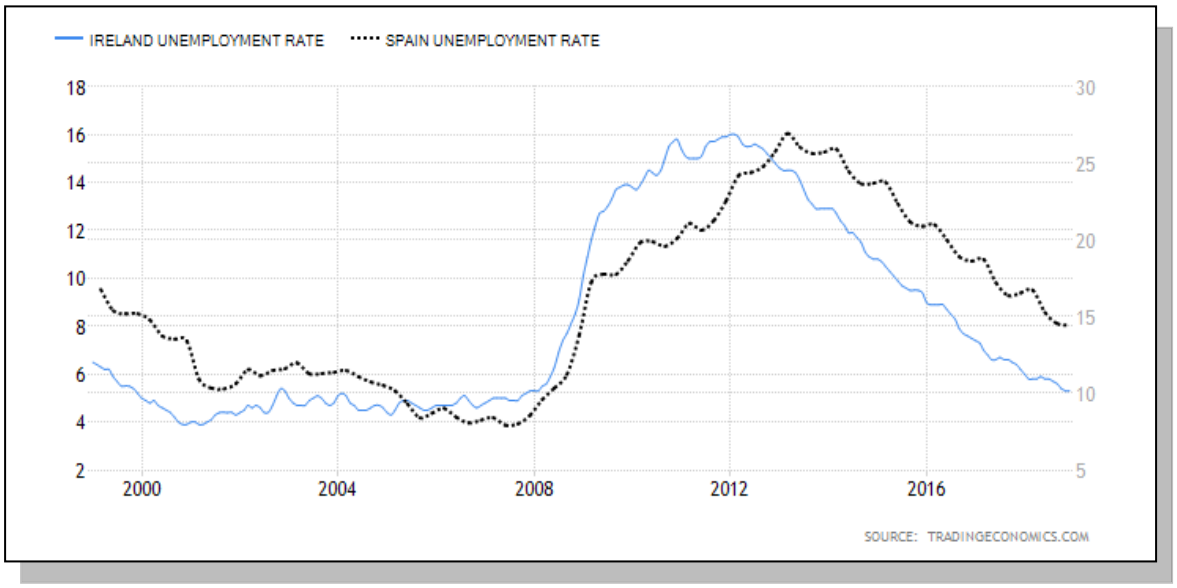
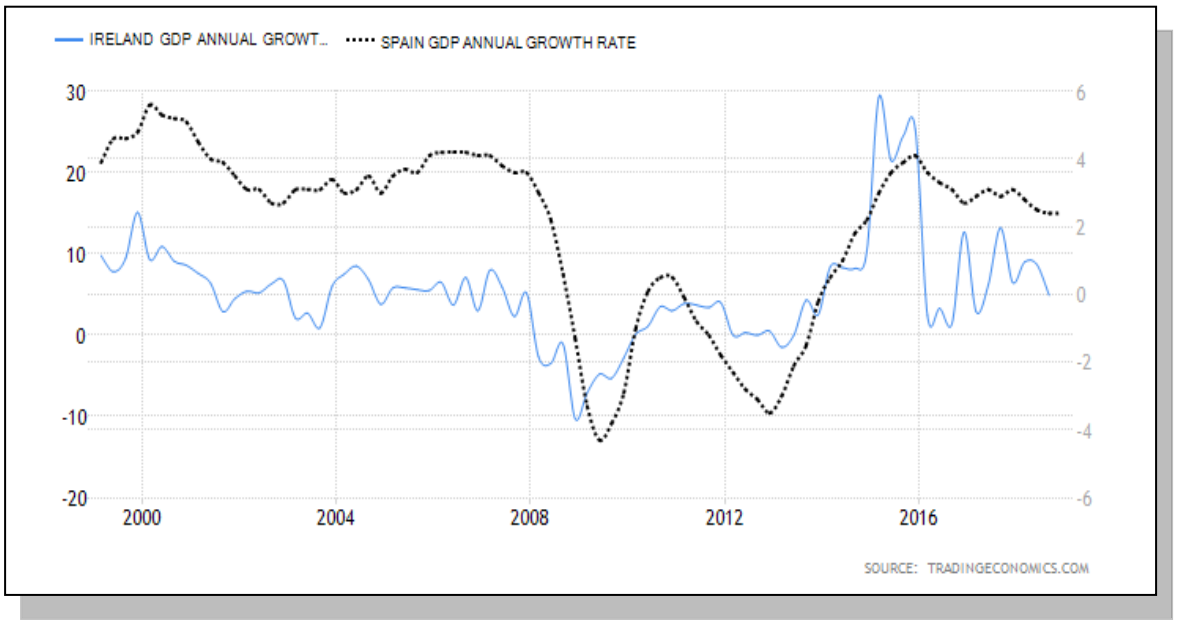


Figure 11.1 A comparison between Spanish and Irish GDP Annual Growth Rate 1999-2018[349]



[348] Trading Economics, A comparison between Spanish and Irish Unemployment rate, https://tradingeconomics.com/ireland/unemployment-rate, consulted on the 2nd February 2018.

[349] Trading Economics, A comparison between Spanish and Irish GDP Annual Growth Rate, https://tradingeconomics.com/ireland/gdp-growth-annual, consulted on the 2nd February 2018.

PART THREE

Design failures in the Eurozone

2.3. Creating a fragile Eurozone: A hybrid monetary system

Even though the European Economic integration stands as a great political success, the Eurozone governance and structure is still a fragile construction which requires some improvements for enhancing a stronger stability and a survival of the Eurozone. Indeed, even though it moves around a single common currency, it does not have neither a state nor a sovereign. To worsen, Eurozone is still not enriched with a solid and robust institutional mechanism for providing both economic adjustments while delivering counter-cyclical fiscal policies for overcoming economic shocks[350]. As a result, the solidity and the stability of this system is still weak, raising questions whether the EMU should be further implemented in the direction of a political and fiscal union or dismantled.

One of the major problems of the Eurozone is related to a controversial and debatable point. On the one hand, monetary policy has been centralized; on the other, as fiscal policies, have remained at national level. Yet, being imperfect and inefficient and modelled upon German fiscal model, they have not only contributed to create further divergence and imbalances among the European countries but they have also highlighted that European countries cannot simply imitate political economies of other countries[351].

In order to ensure a more stable monetary union, a complete and effective banking union might be needed even though it would still not be sufficient. Surely, the Eurozone's intention on making progress on this field is an efficient tool to verify whether Europe will undergo a prosperous period relying on major stability and growth but creating a monetary union is something more than ''simply'' abandoning domestic monetary policies[352].

2.3.1. European Central Bank (ECB): An excessive attention to price stability and inflation?

The European Central Bank (ECB) stands as a milestone in the complex process of European integration. Being the most federal institution of the European Union, it was created as a supranational and independent body, with its own legal personality[353].

---

[350] A. Bénassy-Quére, ''A sovereignless currency'', in R. Baldwin, F. Giavazzi, (edited by), *How to fix Europe's monetary union*, London, CEPR Press, 2016, p. 62.

[351] Economic, fiscal and social policies have been left in the hand of the national governments. Uncoordinated wage policies among the European member countries have created divergent positions, especially, in terms of competitiveness, which have pushed the European countries to tremendous wage cuts incurring into a deflationary force. Similarly, since social policies and structural reforms have remained at national level, a structural divergence has emerged also in terms of employment and output. P. De Grauwe, ''The fragility of the Eurozone's institutions'', cit., p. 172.

[352] B. Eichengreen, ''The Eurozone crisis: the theory of optimum currency areas bites back'', cit., pp. 7- 8.

[353] Art. 9, Protocol 4, Consolidated version of the Treaty on the Functioning of the European Union, Official journal, C326 [2012].

According to the statute and treaty, the ECB and the European System of Central Banks (ESCB) are the only body in the Eurozone entitled with establishing both monetary and interest-rate policies for the whole Eurozone countries while guaranteeing a currency zone stability[354]. Being fiscal and economic policies kept at national level, the Eurozone is based on a mixture of centralized and decentralized features[355].

Monetary policy is now fully centralized and decided by the ECB. Its construction was based on two strong premises: (1) Independence and insulation from any political pressures and interferences and from any connection to national budgets with the aim of avoiding national debt and deficit monetization and (2) an enormous attention to price stability under Art. 2 of the Statute, suggesting that other matters, i.e. employment and growth, are of secondary importance[356].

Although the tasks are clearly expressed in the Treaties, the ECB has sometimes acted beyond the field of competence defined also by its Statute[357].

Being strongly pressured by Germany, the ECB, like other global central banks, has given excessive attention to price stability[358]. A similar monetary policy raised even fears over the possibility that the ECB would have acted really slow in time of crisis, which is, exactly, what happened. Indeed, the Central Bank adopted a conservative approach that have left apart other major concerns, such as higher economic growth[359].

---

[354] Art. 127, Consolidated version of the Treaty on the Functioning of the European Union, Official journal, C326 [2012].

[355] The institutional arrangements of the ECB and the European System of Central Banks (ESCB) resemble those of a federal system to the extent that some similarities can be found in the FED. In order to prepare, implement and conduct the monetary policy, the ECB is thus composed of the Governing Council, where policy decisions are taken upon an equal vote for all the national banks governors that are part of the Eurozone; the Executive Board and the General Council. On the contrary, the FED is still a federal system but more centralized than the ECB. On the one hand, the FED is led by a fixed and stable number of national central banks (twelve banks) in contrast to the Eurozone where they varies. Moreover, voting procedures in the FED are different being more restricted and established upon a permanent voting right. I. Tache, A. L. Danu, ‘’Comparison between the European Central Bank as a new monetary experiment and other major central banks - US Federal Reserve and Bank of Japan’’, *Bulletin of the Transilvania University of Brasov*, VII, V (2014), p. 298-299.

[356] The ECB’s independence is established upon Art. 129 TFEU and Art. 130 TFEU, which also express that the Treaty can be modified only and exclusively upon consensus of all the member states. The ECB and the ESCB can in no way be influenced by instructions and decisions of the national governments. Central bank independence must be assured so as to anchor credibly inflation. S. Micossi, ‘’The Monetary Policy of the European Central Bank (2002-2015)’’, *CEPS Special Report*, CIX, V (2015), pp. 1-2.

[357] Art. 130, Consolidated version of the Treaty on the Functioning of the European Union, Official journal, C326 [2012].

[358] The ECB is not the only central bank pursuing price stability. Similarly, the FED is focused in pursuing maximum employment, economic growth, price, interest and currency stability and moderate long-term interest rates with the aim of providing financial stability. Also the Bank of Japan is concerned with price stability, which is based on the inflation rate acknowledged as sustainable for meeting the objective in the medium-long term, defined in a positive range of 2% or lower in terms of the Consumer price index (CPI). I. Tache, A. L. Danu, ‘’Comparison between the European Central Bank as a new monetary experiment and other major central banks – US Federal Reserve and Bank of Japan’’, cit., p. 296.

[359] The establishment and the statute of the ECB have been mainly influenced by the German Bundesbank. On

As a result, ECB's ability to pursue its objective has mainly implied either the failure or the success of its monetary policy, whose strategies rely on open market operations, standing facilities and reserve requirements. By establishing a monetary policy focused on Eurozone-wide aggregates while disregarding economic situations in individual countries, the ECB has made significant mistakes that might explain the origins and the causes of the Eurozone crisis[360].

Being established as a hyper-independent central bank, a key aspect of the ECB's monetary policy is based on a quantitative, though not precise, definition of price stability in contrast to other central banks: a target of «below but close 2%», based on the Harmonised Index of Consumer Prices (HICP). Initially, the main instrument to achieve this objective was conducted by means of short-term interest rates, while the operational target of the ECB focused on the Euro Overnight Index Average (EONIA), the average of the unsecured lending transactions in the Euro-area interbank market[361]. By following this policy, the ECB pursued extremely low balance sheets while its monetary policy had been coherent and in line with its target. In the initial years, the ECB adopted a two-pillar strategy by examining financial and monetary variables that could represent a real risk for price stability while conducting analysis of structural developments tha could influence the real economy in the medium-term[362].

However, even though, the ECB has respected this objective, as depicted in Figure 12.1, the inflation target has received excessive attention and has been harshly criticized for being imprecise and asymmetric[363].

The ECB's inflation target is not based on an automatic reaction to deviations in inflation from the prefixed target but is based on a flexible strategy for assessing a response to price shocks or threat to prices. This monetary policy is much more suitable for the Core countries than the Periphery, being

---

the one hand, the independence of central bank stems directly from the West-German experience. Being the Bundesbank independent from any political influence, Germany enjoyed both growth and economic stability. On the other hand, the Bundesbank was mainly focused on keeping price stability through low inflation to the extent that Germany pursued low inflation since 1961 while under the EMS, European countries pegged their currency to the Deutschemark. M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions*, cit., p. 113.

360 D. Beckworth, ''The Monetary Policy Origins of the Eurozone Crisis'', cit., p. 7.

361 The EONIA rate was controlled through four different instruments: (1) main refinancing operations (MROs); (2) monthly long-term refinancing operations (LTROs); (3) marginal lending and deposit facilities and (4) reserve requirements for banks amounting at 2% of bank liabilities, such as customers deposits and debt securities with a maturity, below two years. G. Claeys, ''How should the European Central Bank normalise its monetary policy?'', *Bruegel policy contribution,* XXXI, X (2017), p.3 .

362 The first pillar on which the ECB relies is the determination of an interest-rate, which is appropriate to achieve price stability. An excessive or a too low inflation can harm the monetary policy, preventing to reach price stability. On the contrary, the second pillar refers to the set of instruments and tools for achieving the desired interest rate, by buying or selling any marketable instruments or by conducting credit-operations. S. Micossi, ''The Monetary Policy of the European Central Bank (2002-2015)'', cit., pp. 3-4.

363 Critics over the imprecise definition are driven by the fact that ECB specifies the upper limits of inflation level while neglecting the lower one, which may result in difficulties on behalf of banks in respecting inflation expectations. As a result, the ECB should also clarify a lower boundary for preventing any risks. M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions*, cit., p.117.

perceived as more pro-cyclical. Hence, the «*one-size-fits-all policy*», besides being incompatible for diverse regions, has impacted differently the Euro-countries creating a destabilizing effect. On the one hand, interest rates seem to be too high for countries in recession and on the other, it is too low for countries enjoying enormous growth and economic boom[364]. This also explains why the Core countries are usually reluctant to monetary policy changes.

The actions of the ECB conducted in the first years, especially between 2002-2003, contributed to the financial crisis that occurred later. By adopting low interest-rates, financial speculation was stimulated. It was only in 2006 that the ECB decided to change its strategy by raising interest rates to curb inflation until 2008.

Crisis' years were characterized by a real contraction. Rather than cutting interest rates when it was needed, the ECB opted for keeping them pegged at 4% and continued on this wave, as depicted in Figure 13.1. Hence, the ECB has neglected the right attention to financial imbalances of the time[365].

Surely, the monetary authority should have given enough attention also to prices of financial assets, government bonds, equities and spreads that started rising on the assumption that rates would have been kept high[366].

Central bank policy adjustments were made only with the aim of preserving the inflation-target, while credit conditions in both the Northern and Southern countries were overlooked. The situation changed completely between 2007-2008, when special instruments and facilities were introduced for recapitalizing and refinancing banks that were exposed to enormous stress[367].

By the time, major considerations had been left apart which would have demonstrated, during the 2008 financial crisis, both weaknesses and mistakes of the ECB, such as an excessive attention on inflation and a failure in banking supervision, which before the crisis was left at national level[368]. By adopting a

---

[364] By applying one interest rate in a monetary union, the structural and divergent differences are further marked as it does not take into account the level of the economy and competitiveness. On the one hand, booming countries, such as Germany, enjoy prosperity and growth; on the other, countries in recession suffered more. These divergences are, indeed, reflected in divergent unit-labour costs and in current account imbalances where Southern countries experience continuous deficits while Northern enjoy surpluses. P. De Grauwe, ''Design failures in the Eurozone: can they be fixed?'', cit., p. 6.

[365] Since monetary conditions by the time were tightening as spending was decreasing, the ECB should have cut interest rates rather than raising. As a matter of fact, ECB has been one of the responsible of the severe crisis. A similar policy was applied also in 2010, when ECB decided to raise interest rates to stem inflation. D. Beckworth, ''The Monetary Policy Origins of the Eurozone Crisis'', cit., p. 8.

[366] The decision of tightening monetary policy had enormous consequences. It created expectations that the interest rates would have continued raising, which became reality in 2008 when the ECB raised its interest rates to 4.25% while total money spending started decreasing. A similar situation caused an economic contraction and then, a deep recession in the Eurozone economy affecting differently Eurozone countries. *Ivi*, p. 18-19.

[367] The Eurozone is characterized by a bank-based financial system. As a result, the Eurosystem consists of bank refinancing facilities, that are: (1) short-term operations of one week; (2) long-term refinancing operations of three months; (3) fine-tuning operations, without a standard duration; (4) issuance of debt certificates to foster liquidity; (5) standing facilities at the disposal of banks, such as lending and deposit facility. S. Micossi, ''The Monetary Policy of the European Central Bank (2002-2015)'', cit., p 4.

[368] By the time of the financial crisis, the ECB had been criticized for its excessive focus on inflation, ignoring

tight monetary policy, Eurozone GDP declined, as well as inflation. ECB's monetary policy has thus contributed to weaken economic growth, in favour of low inflation.

Being excessively focused on inflation and underestimating demand-driven changes or supply driven-changes, the European Central Bank has been responsible for the Eurozone economic crisis applying the wrong response. Even though this is a problem of inflation-targeted banks, it is clear that price stability does not guarantee financial stability[369].

This mix of centralized monetary rules and decentralized banking supervision had been ineffective. As a result, the Eurozone financial system was easily exposed to a systemic contagion and an enormous propagation of credit crisis. These two elements together revealed the need of institutional changes by enhancing a centralization of the banking supervision at the Euro-level while strengthening ECB's responsibility over financial stability for keeping bank credit growth under control[370].

The functioning of ECB was restricted by legal constrained set both in Treaties and the Statute, which became a serious problem in time of crisis. Yet, being the European financial system bank-based, Eurozone countries had to rely on the intervention of the central bank for safeguarding the financial stability of the Euroarea. As a matter of fact, the ECB experienced an intense evolution, becoming a lender of last resort and supervisor of the banking system and activating a series of new policies.

---

the financial market for preventing market bubbles and bank credit explosion. Thus, the ECB failed in keeping bank credit under control. Moreover, by the time, ECB was not entitled to supervise the banking system within the Eurozone as this responsibility was still left to the national governments and banks, revealing a failure in the whole Eurozone. P. De Grauwe, ''The Fragility of the Eurozone's Institutions'', cit. p. 169.

[369] D. Beckworth, ''The Monetary Policy Origins of the Eurozone Crisis'', cit., pp. 27-28.

[370] P. De Grauwe, ''The Fragility of the Eurozone's Institutions'', cit., p. 169.

Figure. 12.1. ECB Inflation Rate 1999-2018[371]

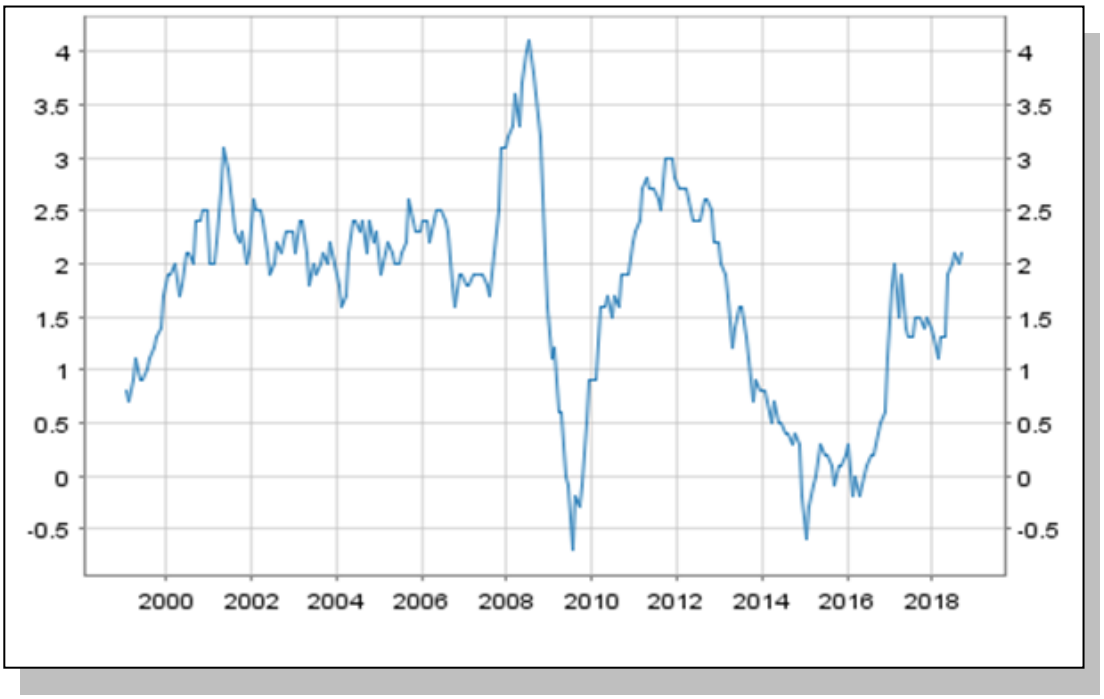
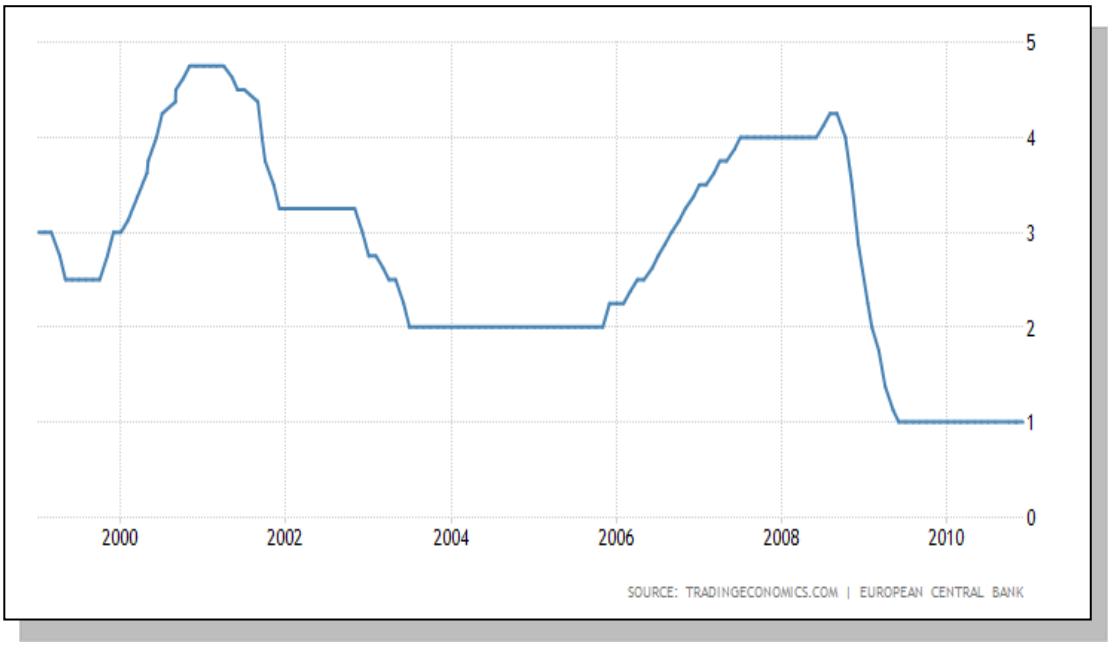


Figure 13.1. ECB interest rate 1999-2010[372]



[371] European Central Bank - Statistical Data Warehouse, Inflation Rate (HICP), http://sdw.ecb.europa.eu/home.do, consulted on the 18th October 2018.

[372] Trading Economics, Euro Area Interest Rate, https://tradingeconomics.com/euro-area/interest-rate, consulted on the 18th October 2018.

2.3.2. The big shift: ECB as crisis-manager and lender of last resort (LOLR)

Over the last years, the European Central Bank has acquired a more political role due to the debt sovereign crisis, which made clear that a central bank should be not only concerned with inflation target but also with financial stability. Nonetheless, one of the main problems in adopting changes in the ECB has been its governance being convinced that it should be focused only on keeping inflation low. Yet, being the Central Bank the only institution able to stabilize the financial system, it should give enough attention also to financial stability[373].

The Central Bank has demonstrated to be an evolving institution. Since the financial crisis, it adopted a different monetary policy opting for unconventional instruments and a change in strategy, even though it might seem that the ECB acted beyond its competences while overcoming its political independence. Nonetheless, the provisions adopted have contributed to provide major progresses in the Eurozone, making the system more resilient[374].

The turning point arrived with the Presidency of Mario Draghi who decided to mirror the FED Reserve policy. Initially, the ECB injected a conspicuous amount of euros for providing financial aid, in time of crisis, to the Periphery countries, through the new long-term refinancing operations (LTROs), at fixed but favorable rates and on a full allotment-basis, with an initial maturity of 3 months, then 6 and finally, one year. This decision was mainly taken to save European banks from bankruptcy.

The LRTOs contributed to raise demand in the bond markets while lowering yields. Even though, it initially succeeded in supporting the sovereign debt market with banks earning easy profits, the mechanism failed. Indeed, it resulted in a lengthening of maturity, followed by an increase in credit risk and finally, a liquidity problem accompanied by an increasing debt stock[375].

The initial steps were taken on the assumption that the Euro-crisis was a liquidity crisis, rather than a solvency one. As a result, liquidity continued to be provided being the European financial market bank-based[376]. However, by the time of Lehman Brothers' collapse, liquidity problems attacked also securities market that revealed an intricate banking and sovereign debt crisis.

Due to the Greek situation, the ECB started adopting significant institutional developments and a new regime change[377]. Showing an incredible flexibility, it embarked in a series of operations and measures to provide an enormous amount of liquidity to banks and financial markets.

---

[373] P. De Grauwe, ''The European Central Bank as Lender of Last Resort in the Government Bond Markets, *CESIFO Economic Studies*, LIX, III (2013), pp. 529-530.

[374] Art. 123 TFEU, clearly asserts that the Euro-countries and the ECB are prohibited from financing, providing credit facilities while the ECB shall be prohibited from buying debt instruments.

[375] The maturity of LTROs were extended because the Euro was losing its common currency status. Greek, Italian and Spanish spread was continuing growing. Hence, the European bond market and the interbank market had become much more segmented while national public debt had moved to national bank books and viceversa. C. Wyplosz, ''The six flaws of the Eurozone'', cit. p. 583.

[376] B. Eichengreen, ''The European Central Bank: from problem to solution'', cit., pp. 16-18.

[377] M. Blyth, *The future of the Euro*, New York, Oxford University Press, 2015, p. 39-40.

In May 2010, the ECB decreased interest rates and launched the Securities Market Programme (SMP). Being driven by concerns and fears over financing directly budget deficits, the monetary authority started purchasing public and private securities with the aim of avoiding a rise in sovereign bond yields. The SMP contributed to decreasing the volatility of sovereign spread in the short-run, even though investors did not feel reassured about the stability of public finances and prices, as deflation was turning into the main threat. Despite ECB's action, economy recovery was still a far mirage[378].

By 2011, the Eurozone was once again involved in widening and explosive spreads. Recession became evident. Yet, the ECB reacted promptly demonstrating its ability to act as a real central bank by providing liquidity in illiquid situations and to be successful in fighting crisis[379].

In Summer 2012, the ECB - under Mario Draghi - announced that it would have done «*whatever it takes*» for saving both Euro and the Eurozone. ECB, thus, started buying government bonds of the Eurozone members - from the secondary markets - through the Outright Monetary Transactions (OMT), provided that the country firstly negotiated a program with the European Stability Mechanism (ESM), in an attempt to regain political independence, previously lost by negotiating directly with Greece[380]. Even though the OMT defeated fears of a debt-run and provided the Eurozone with a major stabilization tool by alleviating the financial markets, it did not contribute to fighting deflation, that, by the time, was developing in the Eurozone economy[381].

These shifts occurred with enormous criticisms. Especially, Germany tried to declare illegal the action with legal objections. The main arguments have been formulated on two assumptions. On the one hand, inflation would have raised due to liquidity injected for purchasing bonds due to as ECB acting as a lender of last resort an and on the other hand, fiscal consequences would have occurred[382]. If

---

[378] The SMP is divided in two waves. In the first stage, ECB bought Greek, Irish and Portuguese debt instruments on the secondary market while in the second step, in August 2011, both Italian and Spanish debts were acquired. B. Eichengreen, ''The European Central Bank: from problem to solution'', cit., pp. 8-9.

[379] In second round of SMP (2011), the ECB purchased covered bondin, injected liquidity and lastly, it decreased interest rates almost to zero. *Ivi*, p. 9.

[380] The Outright Monetary Policy (OMT) contributed to a decline in Eurozone members' spread. This mechanism relies on four crucial criteria: (1) unlimitless; (2) exclusive purchase of bonds government; (3) promised intervention in case of excessive spread and (4) support given only in exchange of conditions imposed by the EFSF and ESM. Points (1) and (2) gave a guarantee for public debt instruments while points (3) and (4) ignored concerned over default risks. C. Wyplosz, ''The six flaws of Eurozone, cit., p. 584.

[381] The period between 2008 and 2011 was characterized by tremendous bond price collapses caused directly by a general panic that was affecting the financial market due to fears of sovereign finances and bank solvency. B. Eichengreen, ''The Eurozone crisis: the theory of optimum currency areas bites back'', cit., p. 8.

[382] Criticism were raised over a possible violation of the Statute, concerning art. 18 of the Protocol of the ECB. Firstly, being government bonds marketable instruments, the ECB did not occur in any violation of the statute besides the fact that no clear clause concerning the prohibition of purchase and selling of bonds in financial markets is actually contained in the statute. On the contrary, the ECB is not allowed to provide any type of credit facility to public entities nor can the ECB acquire debt instrument, as is spelled in art. 21 of the Statute. Nonetheless, the ECB is allowed to buy government bonds in the secondary market. By doing so, the ECB provides liquidity to holders and financial institutions, being interpreted as monetary financing of government budget deficits. P. De Grauwe, ''The European Central Bank as Lender of Last Resort in the Government Bond Markets'', cit., pp. 529-530.

countries had not serviced their debts, then the ECB would have made enormous losses, which would have weighted on taxpayers[383]. However, by acting as a lender of last resort in the banking system, countries were prevented from defaulting.

By calming down the markets and having the ECB defeated speculative attacks in the financial market, overcome fears of a feasible collapse of the Euro and limited the Eurozone's vulnerabilities, the ECB showed that it can actually work as a real central bank. In parallel with an ECB able to cope with a severe sovereign-debt crisis by intervening directly in secondary markets, the creation of the European Stability Mechanism (ESM) has granted financial assistance and provided the Eurozone with a ''shelter'' from terrible crisis[384].

The ECB contributed to the re-establishment of a stabilizing force for both banks and investors. Hence, many years after it came into existence, the European Central Bank acted as real bank being able to pursue its mandate while acting as lender of last resort. Assuming new tasks was a necessary condition for calming down the unstable financial markets, even though it took a long time before playing this role. Had the decision been taken before, probably the Eurozone economic situation would have not been so drastic[385].

Nonetheless, by buying debt securities, the ECB might have violated its independence and undermined the neutrality of monetary policy. Furthermore, with the «*whatever it takes* » announcement, Eurozone countries might have taken for granted that the ECB and the European institutions would have done whatever it is necessary for guaranteeing the survival of the Euro[386]. Indeed, two collateral effects might result: on the one hand, the accumulation of government debt and on the other, a problem of moral hazard. As a consequence, an *ad hoc* governance within Eurozone should be established limiting and containing national debt accumulation, even though some provisions have been already introduced in the European Commission[387].

---

[383] *Ivi*, pp. 522-525.

[384] A. Bénassy, ''A sovereignless currency'', cit., p. 62.

[385] B. Eichengreen, ''The European Central Bank: from problem to solution'', cit., pp. 16-17.

[386] The President of the Central Bank, Mario Draghi clearly expressed that the survival of Euro had to be preserved. He thus stated: «Within our mandate, the ECB is ready to do whatever it takes to preserve the Euro. And believe me, it will be enough. There are some short-term challenges, to say the least. The short-term challenges in our view relate mostly to the financial fragmentation that has taken place in the euro area. Investors retreated within their national boundaries. The interbank market is not functioning. It is only functioning very little within each country by the way, but it is certainly not functioning across countries». Global Investment Conference, Mario Draghi, President of the European Central Bank, 26th July 2012, https://www.youtube.com/watch?v=hMBI50FXDps&t=458s, consulted on the 18th October 2018.

[387] As a result of the sovereign debt crisis, the European Commission has gained much more prominence and voice concerning the supervision of the governments budgetary policies. Indeed, before introducing national budgets, the European Commission is entitled to revise them and to approve or reject them. Similarly, the national policies have already adopted, at national level, certain measures such as the Fiscal Compact and Six Pack, that should contribute to avoid debt accumulation and deficit, while pursuing structural budgets. P. De Grauwe, ''The European Central Bank as Lender of Last Resort in the Government Bond Markets'', pp. 527-528.

Surely, the mechanisms adopted by the ECB – both SMP and OMT – have provided a significant shift and transition in the monetary policy in an attempt to normalize a smooth functioning of the Eurozone. Even though ECB was prohibited from financing governments, the OMT allowed to bypass partially this provision, supporting government debt markets[388].

The main problem affecting the Eurozone relies on the creation of a monetary union without a sovereign state and a complete structure. Basically, states transferred their monetary policy at a centralized European level on the assumption that they would have guaranteed fiscal balances without incurring into violations or fiscal profligacy. Yet, this mechanism failed and resulted into a catastrophic systemic crisis[389].

The major concern is thus whether the single currency can continue working without a more effective political integration. Being the Eurozone *an irreversible project*, a solid European banking union will be needed for providing a major stability of the Euro and finally, as a mechanism for identifying insolvent banks while assuring the necessary financial structure and capital flow. By strengthening its governance and apparatus, shocks affecting the states might be better addressed and prevented.

One of the main problems is that the European institutions have lost the political support needed for a tighter European integration as the Euro-countries were bombed with structural reforms and austerity. Nonetheless, the Euro and the Eurozone need a more solid economic structure and governance.

Some achievements have been already reached in the direction of a Banking Union which was launched in 2012, even though further steps should be adopted, especially for introducing mechanisms for economic adjustments. Supervision of the banking sector has been already implemented through three important mechanisms: (1) Single Supervisory Mechanism (SSM), that acknowledges the ECB as Single Supervisor but supervises only systemic banks still leaving some supervision to national banks, with financial sector, anti-money laundering and consumer protection left at national level; (2) the European Systemic Risk Board (ESRB), a regulatory authority led by the ECB, introduced for strengthening the EMU as a currency union making Eurozone banks more resilient, coordinating fiscal policies and simplifying decision-making and (3) the Single Rulebook, establishing common rules and requirements for all banks thus, safeguarding financial stability[390].

Nonetheless, supervision is not totally assigned to the ECB. This approach still compromises the fragility of the system. Keeping banking and financial supervision and monetary policy as two distinct spheres is dangerous and risky. Bank resolutions should be centralized since bank failures are the result of imperfect central resolutions. By sharing this responsibility at EU level, a better coordination and stabilization of the currency-area should be guaranteed. Yet, risk-sharing is still fragmented and

[388] D. Gross, ‘’The Eurozone crisis and foreign debt’’, cit., p. 125-126.
[389] A. Bénassy, ‘’A sovereignless currency’’, cit., p. 64.
[390] J. Jager, K. Hafner, ‘’The Optimum Currency Area Theory and the EMU’’, cit., p. 319.

kept at a national level, even though countries started to share it by creating the Single Resolution Fund with the aim of reducing risk at banking level [391].

Within the crisis framework, the ECB has demonstrated to be able to expand its responsibilities and acquire new competencies, within the Central Bank's Statute and without requiring any further treaty change[392]. However, the ECB's new role is not sufficient for ensuring the survival of the monetary union, even though it has contributed to reduce the risk of financial instability and implosion.

The sustainability of the Eurozone is surrounded by an increasing skepticism. On the one hand, the monetary union is highly indebted; on the other, it lacks all the adjustment mechanisms for providing a better response to asymmetric shocks, ranging from wage and price flexibility to sufficient labour mobility.

Even though the ECB is gradually becoming a normal central bank, it should maintain its independent position without exercising any pressure for the introduction and application of structural reforms, respecting its statute and mandate. If the ECB gets too involved in budgetary policies, it risks to further endanger and compromise its political independence[393].

The proper separation of the responsibilities should be undoubtedly kept and the ECB should deal with problems it can face. Structural reforms are, indeed, political reforms that should not be influenced by central banks. On the contrary, to improve the ECB, its attention should be redirected also on pursuing financial stability as a primary objective, overcoming the business model still prevalent in Frankfurt, focused on price stability, even if this might imply some losses for the ECB's balance sheet[394].

As it is today, the Eurozone does not constitute neither an optimum currency area nor an embedded currency area.

Even though a series of institutions have been introduced, a state-like governance structure for leading the currency creation is still lacking. Therefore, further regulatory and institutional developments should be integrated, such as common deposit insurance, a single bank resolution program or a common fiscal barrier for sheltering the Eurozone from a further possible crisis. The governance of the

---

[391] Post-financial crisis, a Single Resolution Mechanism (SRM) was settled. This body establishes that resolutions must be carried at national level under the supervision of the Single Resolution Board. Hence, authority is divided between national and supranational institutions. Under emergency conditions, resources are provided to states in difficulties through the Single Resolution Fund, which is built through bank contributions to reach 1% of bank deposits. C. Wyplosz, ''The six flaws of Eurozone'', p. 578.

[392] Art. 127(6) TFEU: «The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings».

[393] B. Eichengreen, The Eurozone crisis: the theory of optimum currency areas bites back, cit., pp. 8-10.

[394] The business model on which the ECB relies is based on particular attention to the quality of balance sheet, with the aim of avoiding significant losses and registering a positive equity. Particularly surprising is the attention given by the ECB to the amount of equities. Yet, what the Central Bank needs is political support of the sovereigns. P. De Grauwe, ''The European Central Bank as Lender of Last Resort in the Government Bond Markets'', cit., pp. 526.

Eurozone should be further implemented even though some changes have already occurred and European citizens might be reluctant to move forward[395]. The Euro-crisis introduced debates whether keeping Euro or leaving Eurozone. The second option might be costly and catastrophic not only for the Euro-members but also for the global financial markets since the quantity of Euros injected in the market, since its launching, is enormous.

2.3.3. ECB vs. unconventional monetary policies: Is it the right approach?

As soon as the global crisis emerged, the global financial market was devastated by increasing debt and liquidity problems. Most of the global central banks responded to macroeconomic conditions by cutting interest rates substantially in various attempts to contain collapse in economic growth and avoid deflation. Since the financial crisis, the Euro Area has experienced a very slow recovery and a massive drop in the level of investments[396].

To tackle the crisis, the ECB has gradually abandoned its conventional monetary policies focused on fighting inflation. Being the initial provisions, such as the injection of liquidity and LTROs, insufficient for improving the Eurozone scenario, the ECB adopted a series of very unconventional monetary policy within its mandate. Therefore, it has increased the instrumental tools through which it provides monetary stimulus in an attempt to overcome the financial and economic crisis and solve the unstable scenario affected by high unemployment, weak growth, high public debt and lack of fiscal stimulus[397].

As depicted in Figure 14.1, the monetary policy has been conducted through the introduction of an interest rate at the Zero Lower Bound (ZLB), very close to zero for keeping a level of inflation safe while introducing financial adjustments. A similar approach requested additional monetary policy tools based on new programmes for purchasing securities and forward guidance over expectations of interest rates for monetary policy accommodation while preventing volatility[398]. By adopting this

[395] According to the Eurobarometer, European citizens are satisfied and trust European institutions, with the only exception of Greece (69% mistrust in the European institutions but a 69% in favour of a single currency), which stresses that the European Union is considered positively. Despite this strong trust and support, it seems that, at least for the moment, Euro-countries have not a particular interest in proceeding forward with a major transfer of national sovereignty at European level. European Commission, Eurobarometer Interactive, https://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/Chart/index, consulted on the 10th October 2018.

[396] N. Carnot, U. Clemens, M. Larch, B. Vasicek, ‘’The policy mix, when monetary policy is constrained at the zero lower bound (ZLB)’’, Quarterly Report on the Euro Area (QREA), DG ECOFIN, European Commission, XV, III (2016), p. 19.

[397] Central banks pursue unconventional monetary policies with the scope of readdressing distortions and adjustments in transmission mechanism and to relaunch the real economy. Especially in time of crisis, implementing monetary policy is extremely difficult for several reasons: (1) increase in demand for reserves; (2) disruption of transmission channel due to financial tensions and (3) insufficient policy rate for stimulating demand due to the ZLB. D. Yilmaz, ‘’Unconventional Monetary Policies in the Eurozone: Considering Theoretical Background and Policy Outcomes’’, *Business and Economics Research Journal*, VI, III (2015), p. 52.

[398] Monetary policy is based on long-term interest rates that influences the private sector both in borrowing and

strategy, ECB has gradually reduced long-term rates thus decreasing uncertainty in money markets through lower bond-yields.

Even though these provisions are debatable and the ECB has been much more cautious than other central banks, the monetary authority probably proceeded in this way on two assumptions: (1) unconventional policies are effective for stabilizing inflation-expectations and (2) unconventional monetary policies work when ZLB is in course since asset-purchase-program can contribute to a general improvement of the welfare[399]. The main non-standard monetary policies were already adopted in time of crisis: (1) Longer-Term refinancing operations (LTROs); (2) Outright Monetary Transactions (OMT); (3) purchase of financial securities and sovereign bonds and (4) Covered-bond purchase program (CBPP).

Nevertheless, none of these programs was sufficiently convincing the market that sovereign default in the Periphery countries would have not occurred. As a result, starting from 2015, the ECB decided to adopt more radical policies and measures. Quantitative Easing (QE) operations offered a solution to solve the unstable financial scenario. This implied the constant purchase of large quantities of assets through the Enhanced Asset Purchase Programme (EAPP), the Asset Backed Securities Purchase Programme (ABSPP) and a Public Sector Purchase Programme (PSPP)[400]. The ECB supplied a monthly increase of 60 billion euros while increasing inflation up to 2%[401].

Why the ECB delayed so much in taking this decision, in contrast to the US FED that started already in 2008, is surely arguable for two reasons: (1) Eurozone performance would have not been so catastrophic in terms of GDP and unemployment losses; rather, it could have been contained through interest rates and QE and (2) the sovereign debt crisis could have been avoided as it emerged also due to the procrastinated action of the central bank[402].

---

investment decision. Since long-term interest rates are based on expectations, the Central Bank can affect them by announcing future policy rates influencing expectations while guiding markets. D. Yilmaz, ''Unconventional Monetary Policies in the Eurozone: Considering Theoretical Background and Policy Outcomes'', cit., p. 53.

399 The theory of monetary policy claims that when monetary authorities want to improve financial conditions and support the economy in case of ZLB, they can adopt non-standard measures ranging from lending programs, outright asset purchase, forward guidance to longer-term liquidity provisions. These are instruments that have been adopted by the ECB in time of crisis. By keeping interest rates low, the only way to overcome deflation is basically by increasing money supply and increasing inflation expectations. H. Kuroda, The Practice and Theory of Unconventional Monetary Policy, https://www.boj.or.jp/en/announcements/press/koen_2014/data/ko140608a1.pdf , updated on the 7th June 2014, consulted on the 20th October 2018.

400 Quantitative Easing is part of the balance sheet policy. By buying assets, central banks increase bank reserves and credibility. Balance Sheet Policies are used to revive financial institutions and markets in time of financial instability. D. Yilmaz, ''Unconventional Monetary Policies in the Eurozone: Considering Theoretical Background and Policy Outcomes'', cit., p. 54.

401 C. Wyplosz, ''The six flaw of Eurozone'', p. 585.

402 The Federal Reserve started its QE operations, immediately at the end of 2008, as soon as interest-rates were close to the zero lower bound (ZLB). Similarly, the Bank of England committed to the same action from the same year onwards. Thus, by 2012, both banks enjoyed better conditions and economic recovery. C. Wyplosz, ''The six flaws of Eurozone'', cit., pp. 584-587.

Delays in taking a concrete decision were caused by two main reasons. On the one hand, the ECB was cautious in launching new programmes as it wanted to respect its mandate. On the other, Germany was reluctant due to its obsession for inflation. Once adopted, all these tools were used for saving and protecting the banking system while avoiding Eurozone financial collapse.

Liquidity in the banking sector was increased enormously, providing an open and unlimited access to the ECB for avoiding credit crunch. Furthermore, the Central Bank was already buying assets, since 2010, in an attempt to save and revive the covered bond market. In this way, an even worst-case scenario in Europe was avoided.

The Central Bank could have done much more. Yet, it was hindered from performing more functions due to a lack of political agreement among Eurozone countries and the legal and structural environment in which it operates. Eurozone financial market is, indeed, built on a bank-based financing and non-financial corporations.

The unconventional instruments for implementing monetary policy affected the economy in different way. The most evident outcome occurred in quadruplicating the size of the balance sheet, as depicted in Figure 15.1. Moreover, by keeping also interest rates very low, major risks have occurred[403].

A large balance sheet prevents the ECB from conducting the monetary policy as it used to do it, by using variable-rate and fixed-volume refinancing operations - through the main refinancing operations (MRO) and the Long-term-refinancing-operations (LTRO) - to control the EONIA rate. Indeed, a large balance sheet and an excessive liquidity reduce the scope of action of the main refinancing operations (MROs) on the EONIA rate[404].

The functioning of the short-term EONIA rate must be guaranteed, even though it is not important how. In the last years, it has been controlled by means of the deposit rate. Moreover, despite the excessive liquidity, the EONIA rate has been stable and less volatile than in the pre-crisis

[403] A large balance sheet can result in higher liquidity level, bringing to rapid credit creation and consequently, to higher inflation that could compromise the ECB's target (price stability). Excessive reserves in the banking sector - due to bank borrowing - can also compromise the action of private banks to manage their liquidity relying too much on the ECB. Finally, also seigniorage profits can be enormously reduced increasing risk of financial losses for central banks. Nonetheless, by keeping large balance sheets, short-term safe assets are provided to the financial market and the economy in the form of reserves. Low interest rates can enhance moral hazard preventing states from adopting fiscal adjustments that could contribute to a better functioning of the markets and a reorganization of the balance sheets, creation of speculative bubbles**,** boom and bust cycles associated to growth reduction. Indeed, due to a distortion in investors' minds, they might be attracted by increasing their spending and could simultaneously slow down a potential growth reducing production, innovation and resources reallocation. S. Eijffinger and L. Hoogduin, ''ECB: Quo vadis?'', *Intereconomics*, LIII, III (2018), p. 171.

[404] Before the crisis, the EONIA was controlled through a variable-rate fixed-volume refinancing operations, namely the MRO and LTRO, accompanied by rates of deposits and marginal lending facilities, a small balance sheet and reserve requirements amounting up to 2%. This system guaranteed a very efficient and operational framework in which the interbank rate was oscillating very close to the MRO rate. G. Claeys, ''How should the European Central Bank normalizes its monetary policy?'', cit., pp. 11-13.

management, even though a reduction in exchanged volumes on the Euro interbank-market has emerged[405].

By inducing a disequilibrium of low interest rates and introducing the QE in the monetary policy, the ECB contributed to a very limited recovery and positive effect after the crisis due to weak credit growth. On the one hand, inflation is rising slowly with a small increase in GDP; on the other, unemployment is still high while bond yields have fallen modestly[406]. It seems that the QE has had very modest beneficial effects on the economy while benefits have emerged in terms of portfolio and narrowing of bond yields among the Eurozone countries[407].

A monetary policy focused on low inflation rates impacts directly also the capital market. Indeed, the behaviour of market parties is more influenced by the ECB monetary policy and less attracted by the creditworthiness of the debt instruments. Finally, a similar monetary policy, based on forced low interest rates, can undermine both ECB credibility and support[408].

Generally speaking, the Central Bank has brilliantly acted in time of crisis and after the crisis for providing an increasing Eurozone financial stability. The monetary authority has, indeed, contributed to creating a more sound and solid financial environment by calming down financial stress through balance sheet policies and also forward guidance. Nonetheless, the ECB's monetary policy has not been able to transmit a real impulse in the real economy. Recovery is still low as also credit to real economy. Moreover, structural weaknesses in the Eurozone still persist with evident divergences in terms of competitiveness, unemployment rates and account imbalances between the Core and Periphery countries.

Even if the ECB has acted more or less successfully, it cannot act alone. It is up to European leaders and policy-makers to adopt structural and innovative reforms.

Hence, considerations over a normalisation of the monetary policy have emerged, even though a roadmap or initial plan has been already presented: (1) reduction of assets purchase; (2) increase of interest rates and (3) reinvestment of the assets' maturity. Moreover, being the European financial market bank-based, the ECB should foster a safe and stable financial market by providing a prudential regulation and solid supervision while promoting market discipline and good liquidity management.

---

[405] The provision of liquidity in the system before the crisis was demand-driven. Basically, the ECB was injecting a large amount of liquidity so that the interbank market could have cashed in at an interest rate close to the MRO rate. As a result, the market was extremely artificial leading also to a lack of market discipline and efficient monitoring before interacting on the market. On the contrary, once the financial crisis appeared, the market stopped while liquidity stalled. As a result, banks demanded more reserves for refinancing operations so as to prevent liquidity shortfall. This established a supply-driven market, created by the ECB's reserves for repaying everything. G. Claeys, ''How should the European Central Bank normalizes its monetary policy?'', p. 13.

[406] N. Carnot, U. Clemens, M. Larch, B. Vasicek, ''The policy mix, when monetary policy is constrained at the zero lower bound (ZLB)'', cit., p. 23.

[407] J. Driffill, ''Unconventional Monetary Policy in Eurozone'', *Open Economic Review*, XXVII, II (2015), pp.17-19.

[408] S. Eijffinger and L. Hoogduin, ''ECB: Quo vadis?'', cit., p. 171.

Figure 14.1. ECB interest rate 2008-2018: the Zero Lower Bound[409]

Figure 15.1. EU Central Bank Balance Sheet 1999-2019[410]

[409] Trading Economics, Euro Area Interest Rate, https://tradingeconomics.com/euro-area/interest-rate, consulter on the 18th October 2018.

[410] Trading Economics, Euro Area Central Bank Balance Sheet, https://tradingeconomics.com/euro-area/central-bank-balance-sheet, consulted on the 18th January 2018.

2.3.4. Economic policies in the Eurozone: A climax of fragilities

Being fiscal policies asymmetrically coordinated, Eurozone countries are further exposed to adverse shocks which seriously compromise the functioning and sustainability of the monetary union.

The Eurozone is, currently, trapped into a twofold problem: (1) a centralized monetary policy with an inefficient decentralized fiscal policy with the latter committed to respecting European rules and provisions, which affects national flexibility and maneuvers and (2) the lack of a Eurozone budget for setting up an insurance system against asymmetric shocks[411]. What is missing in the Eurozone is the ability to prevent or at least, contain asymmetric shocks even though flexibility is awarded in case of severe economic downturns or unusual events. Eurozone leaders are, indeed, convinced of the fact that asymmetric shocks should be solved only through fiscal policies.

Fiscal policy in the Eurozone is the only tool available for countries to advance a counter-cyclical effect, even though it risks to raise a spill-over problem. While monetary policy is centralised, economic policies are left at a national level, as written down in the Treaties[412]. On the one hand, the ECB applies a monetary policy identical to every Eurozone member-state; on the other, Euro-countries are still entitled to address national fiscal policies for overcoming regional imbalances and asymmetries. Yet, consequences of this approach are manifested at European level where the ECB is forced to intervene for limiting potential costs, fluctuations and economic disturbances and to keep price stability thus giving credit to the Taylor Rule [413].

Hence, one of the main problems affecting the Eurozone is the fact that macroeconomic stabilization mechanisms are split between national sovereignty and European Central Bank[414].

---

[411] As A. Bénassy-Quére claims, within the Eurozone, there exists 19 different national budgets which tend to be pro-cyclical or neutral and sometimes, violate both fiscal discipline and European rules. A. Bénassy-Quére, ‘’A sovereignless currency’’, cit., p. 69.

[412] Art. 127(1)(2), Consolidated version of the Treaty on the Functioning of the European Union, Official journal, C326 [2012].

[413] Countries, such as Germany, France and Italy, have applied a series of fiscal policy, both expansionary and contractionary, to achieve a desired level of income and growth or defeat an undesirable unemployment rate. Yet, it has come at the cost of violating the Stability and Growth Pact (SGP) by expanding budget deficits and debt-to-GDP ratio, which otherwise would have limited their policy maneuver. By adopting a similar approach, EMU countries surely bore the costs by means of an effective monetary policy of the ECB for counterbalancing inflationary pressure. M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions*, cit. p. 128. According to the most accepted monetary rule, the Taylor Rule, the monetary authority should respond to both prices and demand changes in order to maintain price stability and defeat inflation. As a result, the authority adopts a more targeted interest rate, if inflation increases or decreases, deviating from its target. This change in interest rates could however show its consequences two years later.

[414] As A. Bénassy-Quére highlights, within the Eurozone, macroeconomic stabilization tools are ‘’split’’ between national budgets dealing with asymmetric shocks affecting the structural economy and stabilization mechanisms for aggregate shocks. A similar division has implied a three-fold problem: (1) an insufficient market discipline and rigor; (2) a lacking attention to financial risks resulting in negative spillovers and (3) an ECB’s incapacity of responding to negative demand shocks. A. Bénassy-Quére, ‘’A sovereignless currency’’, cit., p. 66.

Fiscal policies are a very important ingredient for ensuring the stability of a monetary union, especially for compensating the loss of monetary policy. However, rather than opting for a centralization of economic-fiscal policies, Eurozone members have preferred a coordination[415].

The Eurozone fiscal architecture is very complex and ambiguous. Indeed, fiscal policy is left as a decentralized matter while fiscal discipline is requested at European level[416]. A similar approach is due to two factors: (1) the willingness to keep autonomy and sovereignty within the national state, reflecting also the limits of a deeper integration and (2) the wish of protecting the political independence of the European Central Bank while avoiding a mere «*gouvernment économique*».

Surely, the decision of keeping a decentralized fiscal policies, tailoring specific reforms for specific national needs, might be desirable if states have great control on national budgets to counterattack specific asymmetric shocks. However, this is not the case of the Eurozone since national budgets must conform with the European rules. Hence, economic policy relies on a decentralization but on a coordination of fiscal and structural policies under the supervision of the European Commission. Fiscal discipline, in particular, is imposed by two instruments: (1) excessive deficit procedure (EDP) set up in the Stability and Growth Pact (SGP) and (2) the *no-bail-out clause*, whose credibility has been weakened in time of crisis[417].

The SGP was supposed to provide a cornerstone for the management and governance of fiscal policies combining rules for deficit and debt to be kept within the right boundaries. Nonetheless, *an escape clause* was introduced[418].

Even if it was introduced as stringent mechanism for pursuing sustainable fiscal policies, the SGP has been set up on a very weak institutional basis due to an enormous flexibility which has left for some discretion[419]. Hence, the Pact has reversed into a failure losing gradually credibility. Indeed, it has

---

[415] Art. 5(1), Consolidated version of the Treaty on the Functioning of the European Union, Official journal, C326 [2012].

[416] Art. 126, Consolidated version of the Treaty on the Functioning of the European Union, Official journal, C326 [2012].

[417] The European Commission plays a significant role with regards to policy coordination. It is mainly involved in monitoring member states' economic policies and complains whenever a member-state violate the SGP guidelines. Even if the Commission can take disciplinary measures against the member states, the coordination of fiscal policies is supervised by the Economic and Financial Affairs Council (ECOFIN). D. Hodson, ''Policy Making under Economic and Monetary Union: Crisis, Change and Continuity'', cit. p. 184.

[418] Article 5(1) of Regulation (EU) No 1466/1997, specifies the *escape clause* for EU countries under the Stability and Growth Pact. Whenever member states do not comply with the medium-term budgetary objective, they are required to pursue an improvement in their structural budget balance of 0.5% of GDP as a benchmark. Countries suffering from a debt, exceeding 60% of their GDP, are obliged to pursue an improvement that should be higher than 0.5% of GDP. ECB, Economic Bulletin, https://www.ecb.europa.eu/pub/pdf/other/eb201501_focus07.en.pdf?cbd4c6a71e2fcfdcd36c042c8181cef3, consulted on the 20th October 2018.

[419] The SGP has been revised twice: initially, in 2004, to meet the needs and wishes of both Germany and France that violated the Pact in 2003; and then, in 2012 when the sovereign debt crisis appeared and policymakers asked for a strengthening of the rules by empowering the European Commission. As a result, the body was entitled with major fiscal policy sovereignty (evaluation of the quality of economic policies and pressure in favour of structural reforms). C. Wyplosz, ''The Six Flaws of Eurozone'', pp. 590-591.

compromised directly the behaviours of the budgetary authorities, both in long-term and short-term, affecting stabilization, policy coordination and also, public finances imposing an excessive control and a sanctioning system on the budget deficit. In an attempt to comply with the fiscal discipline, externalities have been generated and these have been intensified through systemic contagion[420].

Despite economic coordination, member states failed in fulfilling fiscal discipline and macroeconomic balances. By disrespecting the 3% deficit threshold and the 60% government debt-to-GDP-ratio, the functioning of the Eurozone has been seriously jeopardized.

To worsen the situation, credibility in the Eurozone concerning policies for budgetary discipline and economic convergence has been damaged. Even though, the SGP has been more or less successful in keeping low budget deficits, it has not succeeded in lowering debt criterion. Moreover, some countries failed in fulfilling their duty without enormous consequences while others respected the parameters established at European level. This stresses that within the Eurozone, there are some states more committed than others. The breach is, indeed, compensated only through non-binding recommendation and fines[421].

This explosive mixture might also explain why the effects and the consequences of the global financial crisis were amplified bringing the single currency almost to a real collapse[422]. Had been the criteria and account balances respected, the contagion could have better contained.

The sovereign debt and banking crisis revealed many deficiencies of the Eurozone, among which an asymmetry and very soft coordination in macroeconomic policies resulted in different adjustment mechanisms. Not only dit it put more pressure on the system but it also requested significant changes for restoring credibility in the Euro and Eurozone[423]. Yet, EU policy makers and leaders reacted promptly during the crisis by adopting a wave of new procedures and rules. This approach has surely brought significant changes in the European institutions, strategies and targets but it has entrapped the national maneuvers and economic policies.

Most of the changes adopted resulted in a very intricate, bureaucratic and complex set of rules, procedures and surveillance mechanisms[424]. This complexity was the price to be paid for the disrespect

---

[420] C. Wyplosz, ‘’The six flaws of Eurozone’’, cit., p. 574.

[421] D. Hodson, ‘’Policy-Making under Economic and Monetary Union: Crisis, Change and Continuity’’, cit. p. 184.

[422] *Ivi*, pp. 194-195.

[423] Macroeconomic policies in the Eurozone have been mainly driven by the financial markets that resulted in a real split between the Core, experiencing an account surplus and the Periphery countries, suffering from deficit accounts. Hence, the former being creditor have gradually increased spending while the latter have tried to decrease spending. As a result, tight austerity was imposed on the Periphery undergoing an internal devaluation by means of wage and price cuts in contrast to the Core. Inevitably, the asymmetries among countries have been intensified. P. De Grauwe, ‘’Design Failures in the Eurozone: Can they be fixed?’’, cit., p. 23.

[424] The Eurozone fiscal system is extremely complicate and restrictive, insisting on many numerical fiscal rules: (1) excessive deficit over 3%; (2) debt reduction rule over 60%; (3) benchmark structural adjustment amounting up to 0.5% GDP; (4) medium-term objective and (5) expenditures benchmarks with enormous constraints on the growth. L. Odor, ‘’The Good, the Bad and the Ugly: Strengths and Weaknesses of the new

of the no-bail-out clause by creating the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM), that nonetheless contributed to the stability of the Euro-system[425].

A serious commitment for restoring trust is necessary and can be attained only by re-writing more precise rules. Unfortunately, the actual European fiscal framework is based on an overregulated architecture, with many exemptions and exceptions leaving large room for discretion undermining the credibility[426]. A similar flexibility, however, risks to seriously undermine the whole Eurozone-system. As a result, a more solid and binding supervision should be adopted so that fiscal rules would be better respected and implemented. The Eurozone fiscal framework is entrapped in a soft non-binding policy coordination that can seriously compromise and affect the functioning of the whole Eurozone[427].

Moreover, the Eurozone is further weakened by the complete absence of risk-sharing arrangements that could help preventing further financial shocks. Hence, the fiscal framework puts a real burden on the Euro-area that leads constantly to adopt a series of reforms and repeated attempts for strengthening the SGP, such as the ''Six-Pack'', for adjusting the misbehaviour and macroeconomic imbalances through a more serious budget-deficit procedure, of those countries that failed in respecting their commitments[428].

Following the pressure of both Germany and France, a *debt brake* and *a budget balanced rule* have been adopted since 2012. This rule has been inserted not only in the Treaty on Stability, Coordination and Governance (*Fiscal Compact*) but also in the European constitutions through amendments. Hence, it has put even more rules on the already complex Eurozone fiscal structure and architecture since deficits have now to be restricted to 0.5% of GDP[429].

European Fiscal Framework'', *Discussion Papers from Council for Budget Responsibility*, III, (2014), p. 527.

425 The establishment of the European Stability Mechanism (ESM) has compromised the credibility of the no-bail out clause, standing as another inconsistency in the Eurozone design. By overrunning art. 125 TFEU, the ESM provides lending and financial assistance to government in difficulty.

426 L. Odor, ''The Good, the Bad and the Ugly: Strengths and Weaknesses of the new European Fiscal Framework'', cit., p. 523-525.

427 In order to establish a well-functioning fiscal system, fiscal rules should rely on some important criteria, that are: transparency, efficiency, adequacy, consistency, simplicity, flexibility and enforceability. Especially, within a monetary union, enforceability and flexibility stands as the most important trade-off. The European fiscal framework is solid concerning transparency and flexibility but it still too weak on simplicity, enforceability and consistency. *Ivi*, p. 529.

428 The Six Pack, a set of legislative proposals, were advanced by the European Commission in May 2010, in an attempt to adjust and prevent macroeconomic imbalances. This provision was adopted in attempt to overcome the shortcomings of the SGP. Rather than improving the fiscal framework, the Six Pack has kept a similar approach to the SGP: non-binding recommendations, even though for the first time, fines were applied for those countries who failed in respecting the criteria. Imbalances are thus evaluated considering housing bubbles, inflation differences and growth rate. D. Hodson, ''Policy-Making under Economic and Monetary Union: Crisis, Change and Continuity'', cit., pp. 186-187.

429 The transposition of the rule has been supervised by the European Court of Justice. In addition to, countries with a deficit exceeding the 3% threshold were automatic subject to sanctions while those countries with a debt exceeding 60% were required to enhance a debt reduction. A. Tooze, *Crashed: How a Decade of Financial Crises Changed the World*, cit., p.426-427.

Budget rules are, thus, accumulating on top of each other creating confusion and an intricate web of provisions. For the first time, Eurozone member states have decided to transpose a European budget rule at a national level. This step should be seen firstly, as an attempt to seriously commit to respecting fiscal policies and secondly, to adapting national fiscal governance at European level. Despite these measures, the Eurozone has still demonstrated a very low progress towards low debt due the violation by certain countries. Probably, these criteria are simply inefficient at national level[430].

Yet, all these fiscal measures have been focusing on excessive deficits, on the assumption that balances should be in equilibrium, without giving adequate attention to debt levels. This revealed enormous shortcomings. Hence, in an attempt to further promote the economic policy coordination, two more innovations have been adopted: the European Semester and the Two-Pack.

The European Commission has acquired major powers, such as supervision and economic surveillance over national budgets. Therefore, it focuses more on fiscal imbalances and it adopts target-warnings in case of fiscal misbehaviour[431].

Despite important reforms have been adopted, economic policy in the Eurozone still remains decentralized and inefficient. The formulation and implementation of fiscal policies and structural reforms are decided nationally with repercussion at European level. Oppositions to the «*one-size-fits-all*» approach emerge due to the differences among the states, in terms of labour, wage flexibility, national products and labour markets. However, when designing fiscal frameworks, systemic considerations should be taken into account rather than focusing only on fiscal issues. Thus, an effective fiscal system should be created by considering macroeconomic imbalances and the overall framework rather than imposing inefficient rules on debt, deficit and flexibility that can simply undermine the credibility of the EMU.

Normalising not only the monetary and banking policy but also fiscal policy within the Eurozone would surely require enormous changes in the institutions, which will not come without opposition[432].

---

[430] Big countries, such as Germany, France and Italy, have disrespected the SGP by conducting an expansionary pro-cyclical fiscal policy, especially between 1999-2002. M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions,* cit., p. 123.

[431] Under the European Semester, ECOFIN can issue opinions and comments on member states' fiscal plan before national budgets are approved by their national parliaments. As in the case of the Six Pack and the SGP, also these recommendations are non-binding commitments and rely on peer-pressure and consensus-building. The Two-pack has brought significant changes to the EU fiscal surveillance by intensifying it through a ''technical assistance'' procedure, especially in those countries suffering from financial difficulties. Under the Two-Pack, sanctions for failing in complying with the EU norms are neither envisaged nor binding. D. Hodson, ''Policy-Making under Economic and Monetary Union: Crisis, Change and Continuity'', cit., p. 187-188.

[432] Among the European leaders, there exists a very strong impetus and controversy over the approach in fiscal policies. On the one hand, northern countries are ready to transfer substantial powers concerning national budgets at EU level provided that it will prevent fiscal profligacy that brought some countries to almost default and bankruptcy. On the contrary, southern countries prefer to opt for the creation of an economic government provided with new resources of financing and the capacity to advance reflation, namely the reintroduction of prices to normal level after a long period of deflation. P. Hall, ''The Euro crisis and the future of the European Integration'', p. 62.

Nonetheless, the picture must be completed with significant and appropriate arrangements and commitments for overcoming structural deficiencies. According to some scholars, stronger credibility in the Eurozone might be reached by committing more common policies at European level and completing a centralization[433].

However, the application of a «*one-size-fits-all*» principle also in the fiscal field might be even more detrimental for European economies. Fiscal policy stands as the primary and only mechanism of stabilization for adjusting asymmetric shocks within an inefficient and suboptimal currency area.

Tailor-made reforms for the national economic needs are more appropriate to tackle local problems. The extreme fragility and vulnerability of the Eurozone are still evident. Asymmetric shocks cannot be solved with a single monetary policy and common instrument based on an arithmetic average of interest rates. Likewise, austerity programs are not the solutions solving the problems as fiscal contraction and tax spending slow down growth and recovery[434]. Moreover, the Eurozone still lacks the essential mechanisms for deterring excessive deficits and pursuing stable surpluses. The European budget is, indeed, too small and insufficient for providing the stabilization effect that the Eurozone needs.

Solutions need to be found in order to prevent further financial and market crisis. Adequate measures and fiscal rules are needed, even though a further sovereignty transfer seems a far reality. The Eurozone and European integration have been built on the promise that national economic and identities would have been kept and preserved. The key question in the survival of the Eurozone is whether the Euro can be kept even though countries run endemic deficits on their account while other run surpluses. A key of success might lie in the establishment of a credible institutional framework for stabilizing the Euro-economies through a consolidation of the banking union, an expansion of budget and lastly, an implementation or a better coordination of fiscal policy initiatives[435].

---

[433] According to S. Micossi, one possible solution for overcoming structural weaknesses in the Eurozone might be firstly, to entitle the European Commission with more powers concerning the formulation of policies and secondly, to put common economic policies under the scrutiny of the European Parliament. S. Micossi, ‘’What future for the Eurozone?’’, cit., p.7.

[434] The introduction of the austerity programmes has been applied in an asymmetric way. The Periphery countries and, especially, Spain, Ireland and Greece, have suffered from imposed reductions in government spending that have contributed to a decreasing GDP and expansive budget. On the contrary, the Core countries have experienced a different scenario: increasing GDP and spending with solid and steady budgets. M. Baimbridge, P. Whyman, *Crisis in the Eurozone: Causes, Dilemmas and Solutions,*, p. 131.

[435] P. Hall, , ‘’The Euro crisis and the future of the European Integration’, cit., pp. 65-66.

CHAPTER III

REBOOTING EUROZONE:
CREATING A MONETARY UNION THAT (MIGHT) WORK

PART ONE
The great dilemma in Eurozone: Break it up or love it?

3.1. The unifying role of the Euro?

Eurozone is a unique and incredible example of both economic and political integration where Euro emerges as the most tangible symbol of this process. The creation of the European monetary union was an economic idea but established upon political reasons and considerations where the Euro was introduced with the primary aim of ensuring a truly irreversible integration while fully exploiting the benefits of the Single Market[436].

Launching this currency has been the key driver in creating an «ever closer union» among European countries that suffered tremendously in times of war.

Undoubtedly, monetary and economic integration within Europe has created a cooperation among Eastern, Western and Central European countries never seen before[437]. Yet, it moved primarily around

[436] As the economist Paul Krugman wrote, «the creation of the Euro was supposed to be the finest moment in a grand and noble undertaking: the generations-long effort to bring peace, democracy and shared prosperity to a once and frequently war-torn continent. But the architects of the Euro, caught up in their project's sweep and romance, chose to ignore the mundane difficulties a shared currency would predictably encounter. […]. The creation of the Euro was proclaimed the logical next step in this process [promoting political unity]. Once again, economic growth would be fostered with actions that also reinforced European unity. The advantages of a single European currency were obvious. No more need to change money when you arrived in another country; no more uncertainty on the part of importers about what a contract would actually end up costing or on the part of exporters about what promised payment would actually be worth. [..].The case for a transnational currency is, as we've already seen, obvious: it makes doing business easier». New York Times, P. Krugman, Can Europe be saved? https://www.nytimes.com/2011/01/16/magazine/16Europe-t.html, published on the 12th January 2011, consulted on the 9th December 2018.

[437] It should be kept in mind that European integration is not limited to the Western European countries but it extended also to the former Communist countries (Baltic, Adriatic and Black Sea). As Communism collapsed, they were given the chance to join European Union stressing that the Euro would have been part of the ''package''. As a result, three categories have emerged: (1) the first group composed of Slovenia,

the Franco-German axis, contributing to an extremely solid and cohesive collaboration among the two former hostile enemies[438].

The consequences for the creation of the EMU have been substantial and enormous, economically and institutionally, due to the imperfect design that contributed to create asymmetries and divergences. As it appears today, the Eurozone has been the result of different views over the management of a common monetary policy and economic policies, a common single currency and intricate negotiations that conveyed into the establishment of the Maastricht Treaty (amended by the Lisbon Treaty in 2009)[439].

The steps towards the EMU have been, nonetheless, possible thanks to the willingness of European countries to give up their sovereignty in favour of a supernational one thus contributing to a further integration among the countries. They decided to opt for a centralization of a monetary policy focused on targeting inflation instead of wage-coordination due to leaders neoliberal thinking over monetarism, free trade and flexible labour market. On the contrary, they opt for semi-decentralized fiscal policies to promptly respond to internal shocks (without a great success)[440].

In an attempt to avoid spill-overs and free-rider problems, two important rules were introduced (and bypassed): (1) the «*no-bail-out clause*» under art. 125 TFEU and (2) the prohibition of monetary financing and credit facility on behalf of the European Central Bank under art. 123 TFEU[441]. These rules were supposed to bring fiscal discipline, monitor markets-functioning and finally, sovereign risks. The Eurozone architecture was thus further implemented by the introduction of a series fiscal

---

Slovakia, Estonia, Latvia and Lithuania that quickly joined the currency; (2) the second group, not part of Eurozone and composed of Croatia, Romania and Bulgaria (with the latter showing a great interest in joining the Euro during the Bulgaria Presidency of the European Council) and (3) the third group or Visegrad Group, composed of Slovakia, Poland, Czech Republic and Hungary, proud of their monetary policy autonomy and reluctant of joining Euro, which is also stressed by the strong right-populist-anti-Euro wave in their respective countries. L. Andor, ‘’The unifying role of the single currency’’, *Intereconomics*, LIII, IV (2018), pp. 218-220.

438 The Franco-German cooperation has been the key element in building a solid and cohesive partnership that has been surely fostered by personal connections. Initially, Valéry Giscard D’Estaing and Helmut Schmidt cooperated for the establishment of the European Monetary System (ESM). Then, François Mitterand and Helmut Kohl promoted the Maastricht Treaty (1992). Finally, despite the economic and financial crisis, the partnership did not collapse under the former ‘’duo’’ of Angela Merkel and Nicolas Sarkozy, followed by François Hollande. Yet, it became more complicate to introduce new reforms and new provisions, especially due to the different vision over the EMU. Germany conceives it as a rule-based stability union in contrast to France, which perceives it as promoter of growth and financial stability. Nonetheless, with the new Presidency of Emanuel Macron, a new vivid debate over a ‘’Eurozone reform’’ has been opened.

439 G. Claeys, ‘’The missing pieces of the Euro architecture’’, *Brugel Policy Contribution*, XVII, X (2017), p. 2.

440 J. Ryan, ‘’Forgotten Lessons for the Eurozone’’, *European Policy Brief*, XLIII, V (2016), p. 3.

441 Art. 123(1) TFEU: «Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments».

rules under the Growth Stability Pact (SGP) and the following reforms with the aim of limiting both deficit and debt levels.

Despite all efforts, European countries and Eurozone member states have been involved in one of the toughest crisis - between 2008 and 2012 - that revealed defects, fragilities and imperfections in the Euro-architecture. Euro-states were dragged in a double dip recession: firstly, in 2008-2009 and then, in 2011-2012, experiencing a tough sovereign debt crisis[442]. Hence, a further divergence has emerged between the Northern (Core countries) and Southern (Periphery), where the latter have been accused of violating repeatedly fiscal rules[443].

A convenient scapegoat for Eurozone failings and errors was associated with the Maastricht Treaty. In the first years from the establishment of the EMU, it helped to hide economic booms in certain countries - Spain, Ireland and Greece - that were initially considered a sign of economic convergence. Surely, the Euro helped European countries to gain more credibility than they used to. Their commitment to price stability was more firm and serious to the extent that interest rates decreased. Yet, inflation differentials that occurred were wrongly interpreted as a result of a catching-up process that would have contributed to a better convergence and living standards among members of the Euro-area[444]. Nonetheless, this different inflation rates resulted in divergent real interest rates that impacted and enormously influenced investors' behaviours. On the one hand, savings increased in Core countries while on the other, borrowing expanded in the Periphery.

A similar scenario resulted in a credit-pool where significant and large capital flows boosted economies that were already overheated in a monetary union composed of different levels of economic structure. In reality, both imbalances and divergent economic accounts were signalling an increasing disparity among the countries that were hidden by a general balanced aggregate current account[445].

---

[442] G. Claeys, ''How to build a resilient monetary union? Lessons from the Eurocrisis'', *ADBI Working Papers – Asian Development Bank Institute*, DCCLXXVIII, IX (2017), pp. 1-2.

[443] The common narrative focuses on the overspending and public profligacy by the Southern countries that are accused of breaching the 3% threshold. In reality, by taking into account statistics provided by Eurostat, both Spain and Ireland never violated fiscal rules until 2008. Certainly, mistakes were committed, especially by Greece's policies. Nonetheless, the main problem is to be associated with capital flows from the Core to the Periphery and an inefficient architecture that further weakened the countries (through Troika, market and financial fragmentation, increasing unemployment and poverty).

[444] A convergence of nominal yields occurred in the Euroarea government bonds between 2000 and 2007 due to some critical factors and inconsistencies of the Euro-architecture and Maastricht: (1) elimination of exchange rate risk; (2) consideration of riskless sovereign bonds as market discipline was thought to play an important role and (3) consideration of a credible no-bail-out clause. These factors altogether contributed to a non-differentiation of the various bonds. As a result, a convergence in the sovereign yields and both market and interbank rates, which stand as reference for the interest rates for banks to private sectors, occurred. Hence, convergence of nominal rates led to an increasing divergence in interest rates. As a consequence, inflation rates differentials and similar nominal yields resulted in divergent real rates. G. Claeys, ''How to build a resilient monetary union? Lessons from the Eurocrisis'', cit., pp. 3-4.

[445] Eurozone is a monetary union set on the inflation target «close but below 2%» which should require a coordination in wage development. Two of the most important factors in determining inflation are wage-unit and labour-cost growth, which surely have an impact on prices as well. As a result, due to a lack of

In time of crisis, all these countries were hindered in using adjustment mechanisms for overcoming the unstable situation and defeating the asymmetric imbalances. Besides not having an autonomous monetary policy, they were deprived of exchange rate stabilizers. To worsen the scenario, other mechanisms for absorbing shocks and asymmetries, ranging from labour mobility, capital integration to federal budget, were lacking[446]. Hence, Eurozone members experienced one of the most damaging and severe financial crisis since the Great Depression, advancing considerations over a «Eurozone breaking-up», even though it would not be a desirable option.

Countries entered the global financial crisis revealing the incomplete structure of the monetary union aggravated by two additional factors: firstly, the bitter reality of being a sub-optimum currency area and secondly, an initial unwilling European Central Bank to operate as a Lender of Last Resort (LoLR)[447].

Several crisis management mechanisms were introduced to put an end to the Euro-crisis. Specifically, three significant institutions and mechanisms were set up: (1) the European Stability Mechanism (ESM); (2) the Outright Monetary Transactions (OMT) and the launching of the Banking Union Project by transferring banking supervision at European level and (3) a series of reforms for improving the effectiveness of national imbalances[448].

Despite the adoption of these great mechanisms, the European Economic and Monetary Union is still stuck in a trembling fragile architecture that should be further improved for creating a more resilient structure. To avoid a break-up, convergence, more dialogue and solidarity have to be restored. These can be only achieved by opting for a fundamental Eurozone reform (or at least, a revision) for fostering cohesion and support[449].

---

coordination in the Eurozone, a persistent divergence of inflation occurred due to differences between Eurozone countries in terms of cost and price levels. By accumulating over time, they indeed caused a real exchange rate appreciation (or depreciation). To properly function, the Eurozone should have guaranteed, from the very beginning, a rise in national wage-level in line with productivity while referring also to the inflation target. Since this did not happen, the accumulated gap in unit labour costs resulted in an advantage in terms of trade flow for some countries such as Germany, which affected detrimentally other Eurozone countries. H. Flassbeck, F. Spiecker, ''The Euro – A story of Misunderstanding'', *Intereconomics*, XLVI, IV (2011), pp. 181-182.

[446] Even if Europe has gradually experienced an increasing labour mobility since the 1990s, the rate is still low, if compared to other monetary unions, such as the US. Similarly, concerning financial integration, capital market is still enormously fragmented. On the one hand, short-term interbank market and debt market are more or less functioning. On the other, equity and bonds markets are still lagging behind. Moreover, also risk-sharing instruments are insufficient. Indeed, the EU budget cannot be the right response to shocks due to its small budget size (amounting up to 1% of European GDP economies) and lack of flexibility. G. Claeys, ''How to build a resilient monetary union? Lessons from the Eurocrisis'', cit., pp. 5-6.

[447] Even though the European Central Bank (ECB) emerged as an evolving institution, it actually demonstrated its tendency to react slowly and with enormous delays. Not only did it wait to cut interest rates, when it was needed, but it also procrastinated in introducing the Quantitative Easing (QE) programme, in contrast to the US FED Reserve and Bank of England. J. Ryan, ''Forgotten Lessons for the Eurozone'', cit, p. 6.

[448] G. Claeys, ''The missing pieces of the Euro architecture'', cit., pp. 2-4.

[449] On the 31st May 2017, the European Commission issued a «Reflection Paper on the deepening of the Economic and Monetary Union» insisting on the fact that Euro is something more than a currency – it

The Eurozone is currently at a crossroad complicated by two factors: the wave of sceptic populism, under the outburst of *Euroscepticism* and the Brexit case, which is also putting into question the survival and future of Euro, EMU and the European Union.

Since the political framework is changing, a constructive approach for a reinforced economic integration could be impeded raising any consideration for future scenarios. Indeed, deficits and debts are still high while growth stagnates and unemployment, especially the youth one, is marked by a discouraging rate. Therefore, new measures and provisions must be certainly adopted even though they might raise some trade-off over more or less autonomy in decision-making processes.

3.1.1. Breaking-up Eurozone: «A long, costly and messy divorce»

The adoption of Euro by nineteen different economies is surely an irreversible project, as it was already recognised by the *Delors Report* in 1989 and has been even further stressed by the President of the European Central Bank, Mario Draghi[450].

Politically speaking, the integration of Europe was supposed to create a sense of unity among the countries. The former President of the European Central Bank, Jean-Claude Trichet, praised the creation of economic and monetary union for its increased prosperity, economic growth, better living standards and financial stability[451]. Yet, the reality has been certainly different. One constant factor has been dissatisfaction and discontent accompanied by stagnant and low growth, dramatic intensification of social inequalities and high unemployment[452].

---

affecting all the European citizens, economies and countries. Even though EMU is stronger than it used to be, «what is needed is an overall vision and clear sequencing of what needs to be done» over financial vulnerability, unemployment and the need of more integration in certain fields, such as risk-sharing and risk-reduction. European Commission, ''Reflection on the Deepening of the Economic Monetary Union'', COM (2017) 291, [2017], p. 7.

450 During the ECB Governing Council Meeting 2018, Mario Draghi stated: «The Euro is the currency of 340 million people and enjoys now 74% support across the citizens of the Euro-area, and more countries want to join the Euro today. You can take your conclusions but one conclusion is that it's irreversible because it's strong, because people want it and because it is of no benefit to anybody to discuss its existence». Youtube, Draghi says the euro is irreversible, https://www.youtube.com/watch?v=wuSoD2BcPFY, consulted on the 13th November 2018.

451 The former President of the European Central Bank, Jean-Claude, Trichet stressed at the Brussels Economic Forum on the 16th May 2008: «The introduction of the Euro has been recognised as a remarkable success. Since 1999 the single currency has fully inherited the degree of credibility and confidence that was the privilege of the most credible national currencies before the euro. […]. The average yearly inflation has been 2.1% from the 1st January 1999 up to the end of 2007. Since the setting up of the euro, 15.7 million net new jobs were created, three times more than during the same number of years before the euro and around 2 million more than in the US during the same period». Surely, the reality has been quite different if one takes into consideration balance of payments, credit-fuel boom, the impact of USA and European bubbles and finally, the Eurozone crisis whose impact was longer and deeper than the USA. Currently, the Eurozone is undergoing *a secular stagnation*, made by a sluggish growth (3% lower than before the crisis), increasing unemployment (5.6% higher compared to pre-crisis) and low investments.

452 B. Eichengreen, The Euro: love it or leave it?, https://voxeu.org/article/eurozone-breakup-would-trigger-mother-all-financial-crises, published on the 4th May 2010, consulted on the 17th December 2018.

Whether the Euro can be considered a failure or a success is quite debatable. Firstly, adjustments within Eurozone have been quite uneven and unbalanced. Secondly, economic performance has been quite poor. Lastly, fiscal discipline has never been really respected increasing moral hazard and thus exposing Eurozone to further risks[453]. To worsen this assessment, the ECB has been blamed for its disappointing performance in certain occasions while delaying in taking specific decisions[454].

Besides the fact that EMU is a suboptimal currency area, Eurozone governments have gradually lost their ability of controlling and stabilizing their economies, especially in time of crisis, to the extent that some Euro countries, i.e. Greece and Spain, raised hypothesis over leaving Euro. The perception of a break-up was quite widespread in these countries as they are the one who suffered the most due to austerity, economic decline, social instabilities and political protests[455].

Nonetheless, even though it might be very attractive for some countries to re-adopt their national currencies, it is simply impossible and Eurozone governments and leaders should become aware of this. No legal provision for leaving Eurozone is actually envisaged in the Treaties. Indeed, there are no formal rules and it is not clear whether a country can leave the Euro but remain in the European Union[456]. This implies even more complicated and lengthy negotiations than in the Brexit case. Exiting from the Eurozone would require a very complicated coordination with all member states in order not to endanger stability of the remaining countries' economies within the EMU and to avoid bankruptcy, economic recession or capital flight in the «departing country»[457].

---

[453] Centre for European Reform, ''Conference Report: Has the euro been a failure?'', held on the 6th-7th Novemebr 2015, in Ditchley Park, Oxfordshire, p. 4.

[454] When the ECB was established, it was supposed to emulate the successful German Bundesbank in terms of price stability, inflation, accountability and finally, independence. The ECB's Mandate, established under the Maastricht Treaty, acknowledges the price stability as the main objective. Yet, according to art. 2 of the Protocol on the Statute of ESCB and of the ECB, «without prejudice to the objective of price stability, it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community». This implies supporting non-inflationary and pro-growth policies and finally, a low level of unemployment, even though price stability remains the primary objective. Furthermore, the ECB is the least accountable institution within the European framework to the extent that it cannot be held accountable whenever it exerts power beyond the interpretation of its tasks. The statute of the ECB can be only modified by revising the Treaties, which requires unanimity. J. Ryan, ''Forgotten Lessons for the Eurozone'', *European Policy Brief*, cit., pp. 6-7.

[455] Team Eurozone 2020, ''Future Scenario for the Eurozone: 15 Perspective on the Euro Crisis'', *International Policy Analysis Friedrich Ebert Stiftung*, III (2013), p.4.

[456] Legally speaking, there is no provision in no Treaty over the possibility of leaving Eurozone as the creation of the monetary union was settled down on two considerations: (1) The idea of creating an irreversible economic and monetary union and (2) the irrevocable fixed exchange rates. On the contrary, there exists art. 50 TEU which was introduced through the amending Lisbon Treaty (2009) acknowledging a member state the right to leave the European Union. Office for Official Publications of the European Communities, Protocol on the Transition to the Third Stage of Economic and Monetary Union, Official Journal, C 191 [1992], p. 190.

[457] K. Aslett, J. Caporaso, ''Breaking up is hard to do: why the Eurozone will survive'', *Economies*, IV, IV (2016), p. 9.

Even though the withdrawal might be a plausible solution for some benefits of non-euro membership (monetary autonomy, regain of democratic control, setting of interest and exchange rates), it is quite impossible to know the effective costs of dismantling and breaking-up the Eurozone.

The consequences would be enormous due to economical, political and procedural barriers. Moreover, all the technical difficulties should in no way be underestimated as the effects of leaving the Eurozone might vary depending on the type of country and the economy's size (small as Portugal or Greece or large as Germany or Italy) that abandons the common currency.

Firstly, economically speaking, the creation of the Monetary Union has brought substantial benefits that go along with the Single Market: reduction of exchange rate uncertainty, reduced transaction costs, major credibility for investments in terms of credit ratings and easier access to financial markets. Leaving the Eurozone would imply the re-adoption of national currency and the redenomination of contracts that could raise a further problem: decreasing levels of trade and investment with increasing volatility[458]. As a result, currency conversion could incur into a real devaluation/depreciation against the Euro while leading eventually to further debt problems due to redenomination. A two-fold problem could occur: (1) wage inflation and (2) absence of benefits in terms of external competitiveness[459]. In addition to this, the overall scenario could be further compromised by increasing interest rates on public debt and private debt[460]. Reforming fiscal institutions for contrasting debt-cost might be the only feasible solution for reassuring markets and investors.

Abandoning the Eurozone in an attempt to apply inflationary policies and devalue debt would not be beneficial, especially for countries with high levels of debt and unemployment. A collateral effect might come to surface in terms of credit downgrading and increasing spreads due to investor's fears, expectations and reactions, which might also result in higher interest rates costs and higher inflation. The only solution to overcome a similar scenario would be the adoption of both institutional and

---

[458] Markets could respond immediately to the expectations of redenomination in the domestic currency. Therefore, be the households or the firms, they would certainly shift their deposits and investment in other Euro-area countries as deposits could lose value against Euro. The problem is that, in the worst case scenario, a system-wide bank run could emerge with a bond market crisis. Surely, it is quite debatable that beyond this situation, the ECB would act as a lender of last resort where the country would need a bail out for banks and for buying back its debt. B. Eichengreen, ''The Breakup of the Euro Area'', cit., p. 22.

[459] Surely, leaving Eurozone raises enormous doubts and unknown scenario of what could effectively happen. As Barry Eichengreen suggests, the hypothetical reintroduction of the national currency should be accompanied by structural reforms in the labour market so that real wages would automatically adjust and interest rates would not further increase. Once again, even if they might not be wished, structural reforms would be absolutely required. B. Eichengreen, The Euro: love it or leave it?, cit.

[460] Private debt would be a very tough topic to deal with, in case of a country leaving the Eurozone. Since a lot of private debt is held by other Eurozone countries, it would be very unclear whether this form of debt could be redenominated into the new national currency. Surely, a problem of credibility would appear in this extremely chaotic and unstable situation. Finally, a mutualisation of private debt might be inevitable thus revealing a problem: (1) increasing public debt and (2) market problems. These two factors should be even added to a feasible long-term growth challenge. Centre for European Reform, ''Conference Report: Has the euro been a failure?'', cit., pp. 5-6.

policy reforms to calm down the tumultuous markets[461]. Nonetheless, the economic consequences of abandoning the Eurozone would also possibly deny privileges of having direct access to the single market by limiting freedom of movement, which is also the scenario that is emerging with the Brexit case[462]. Nonetheless there are countries, such as Denmark, that opted-out from the Euro by keeping their national currency and have access to the Single Market.

Secondly, politically speaking, countries leaving Eurozone might lose credibility at European and international level. The creation and further developments of the European Union produced enormous benefits in terms of cooperation among the European countries. The most peaceful period in the European history has been achieved being supported by a solid consolidation of European democracies[463].

Exiting could seriously endanger the European project that could be perceived as a failure and eventually, lead to «*a domino effect*» by means of an «*exit-contagion*» also in the European Union by affecting not only Eurozone but also the Single Market being extremely intertwined[464].

Leaving the Eurozone might seriously put at risk cooperation and European credibility, with Europe possibly losing its influence internationally. Moreover, what could happen is that a departing country might be treated as «*a second class status country*» and might not be really welcomed in negotiations while the remaining countries could be prevented from advancing considerations over leaving by creating disincentives or diminishing their voice[465].

Furthermore, to aggravate the scenario, the dismantling of the Eurozone could gradually lead to an economic and financial chaos resulting then in a political panic as creditor countries might be directly affected by destabilizing effects. Similarly, the co-existence achieved could be substituted by feelings

---

461 B. Eichengreen, ''The Breakup of the Euro Area'' in A. Alesina and F. Giavazzi (edited by) *Europe and the Euro*, Chicago, University of Chicago Press, (2010), pp. 16-17.

462 With the referendum held on the 23rd June 2016, the United Kingdom voted for leaving the European Union, (with a majority of 51.9% for leaving against 48.1% for remaining). As a result, the UK invoked art. 50 TEU to open the tough and intricate negotiations. The UK is, indeed, expected to leave the EU on the 29th March 2019. After a very complicated process, it seems that both parties (UK and EU) came to a 585-page withdrawal agreement (a legally binding text) that sets all the conditions and terms to ensure an amicable divorce, even though it still has to be approved by the House of Commons. One of the most tricky and debated points has been the access to the single market and specifically, whether the UK will continue to have access or not.

463 K. Aslett, J. Caporaso, ''Breaking up is hard to do: why the Eurozone will survive'', cit., p. 12.

464 As the German Chancellor, Angela Markel, once said during a speech held in the Deutscher Bundestag, «the Euro is the guarantor of a unified Europe […]. If the Euro fails, Europe fails. This must not happen». Youtube, Angela Merkel, If the euro fails, Europe fails, https://www.youtube.com/watch?v=_nwbHuP91gc, published on the 26th October 2011, consulted on the 6th January 2019.

465 «*Departing states*» might find themselves in a less privileged position to influence decisions and policy discussion within the European institutions. A loss of influence might accentuate the already existent *democratic deficit* within Europe. As a result, a loss of influence might create incentives for the other states in remaining within the Euro-area. Nonetheless, the exclusion might also create a new block, made by the opt-out countries, such as Sweden and United Kingdom. Surely, the outcome would be extremely uncertain. K. Aslett, J. Caporaso, ''Breaking up is hard to do: why the Eurozone will survive'', cit., p. 12.

of frustration and eventually, discrimination even though the idea of the Euro was based on the assumption that it would have fostered a sense of unity among the European countries[466].

As a result, abandoning Euro would imply neglecting values attached to the single currency and could lead to the disrespect of the *departing country* while increasing hostility, discrimination and misguided stereotypes.

The political costs of dismantling the Eurozone might be so excessive that they could negatively affect and even weaken the other European institutions. The failure of the monetary union could represent a failure for the European political integration. Hence, the dismantlement of the Eurozone can even impact the existence and survival of the European Union, which could turn into a loose cooperative partnership, threatening also the existence of the Single Market (with its four freedoms) and the European Union[467].

Lastly, the real problem in terms of leaving Eurozone lies in the procedural aspects (both technically and legally). The procedure stands as a real obstacle, being the adoption of Euro a very complex social, economic and political process. Initially, there were some technical and also psychological costs due to the new currency and the need of programming the European economy with Euros. Hence, financial dislocation would be the main problem.

By reintroducing a national currency, all contracts, ranging from bonds, mortgages to wages, would have to be redenominated; otherwise risks would emerge in terms of financial distress and bankruptcies caused by the depreciation of the national currency[468]. However, not only the private sectors - bank deposits, bank assets and bank balance sheets - but also the public one - public debt, pensions and government liabilities - would have to be redenominated in the new currency. Undoubtedly, a similar change would result in an excessively expensive process due to a complicated exchange associated also with practices for bookkeeping, accounting and supervision. Lastly, all the European Treaties and provisions (Stability and Growth Pact, Fiscal Compact or Six Pack) would have to be dismantled. Indeed, they created a very complex system and rules designed for the governance of the whole Eurozone and European Union countries[469] .

Reversing a similar historical, political and social process could be extremely risky. Therefore, a similar procedure should be accompanied by both an extensive planning and new national legislature for overcoming the unstable situation, reducing volatility and pressure and avoiding capital flight (for

---

[466] B. Eichengreen, ‘’The Breakup of the Euro Area’’ in A. Alesina and F. Giavazzi (edited by) *Europe and the Euro*, cit., pp. 19-20.

[467] Centre for European Reform, ‘’Conference Report: Has the euro been a failure?’’, cit., , p. 8.

[468] Redenominating contracts, wages, mortgages and so forth on would be extremely difficult. The change would occur from an European currency to a national one raising another problem over which is the most suitable law to be applied. European law could be considered as the law of currency-issuer thus neglecting the possibility of redenominating contracts. Moreover, the situation is further aggravated by the fact that in certain cases, no law is specified in the contracts thus making more complex to choose the applicable law. B. Eichengreen, ‘’The Breakup of the Euro Area’’, cit.., pp. 27-28.

[469] K. Aslett, J. Caporaso, ‘’Breaking up is hard to do: why the Eurozone will survive’’, cit., pp. 10-11.

instance, through mechanisms for limiting withdrawals in the banking system). Two additional considerations should be taken: (1) the need to redefine and re-establish the exchange rate parity that could lead to shift bank deposits from the leaving-country, that intends to abandon Eurozone, to those that want to keep Euro[470] and (2) a revision of all the European Treaties[471].

A very dangerous and damaging vicious circle would emerge possibly resulting in a banking crisis due to bank runs and in a bond-market crisis. Surely, the scenario that could appear is quite unknown and mysterious but what could eventually come to light is a global recession or «*the mother of all financial crisis*», as Barry Eichengreen claims. Financial chaos could undoubtedly occur damaging both economic growth and performance (increasing unemployment and productivity)[472].

Monetary unions have been already dismantled in the past but the nowadays-global reality is much more complicated that it used to be[473]. However, the cost of remaining in the Eurozone might still outweigh the one of dismantling it, even though the second option would ensure a more appropriate autonomous monetary and fiscal policy[474].

By leaving the Euro, deficit problems in the most affected countries (Italy and Greece) would not disappear. The already highly indebted countries could continue suffering becoming even more indebted and less competitive.

Honestly speaking, rather than dismantling the monetary union due to unknown and risky costs, solutions should be found within the current system. Reforming and improving the already existing structure while adopting new mechanisms might be the right approach for improving the current

---

[470] Before proceeding toward the third and last stage of the monetary union, the member state agreed to lock their exchange rates in 1999. A similar pre-commitment excluded the possibility of depressing national currency to obtain a further competitive advantage. Hence, if a country decided to leave Eurozone, this would imply to review the commitment taken, which surely could have significant consequences. B. Eichengreen, ‘’The Euro: love it or leave it?’’, cit.

[471] Surely, it is impossible to know what would and could happen in case of a Eurozone-Breakup or a country leaving Eurozone. Changes in the current European instruments would be needed for reducing uncertainty, improving regulation and strengthening fiscal consolidation in an attempt to avoid increasing unemployment, instabilities, divergences and further impact on social welfare system. Team Eurozone 2020, ‘’Future Scenario for the Eurozone: 15 Perspective on the Euro Crisis’’, cit., pp. 6-7.

[472] B. Eichengreen, ‘’The Euro: love it or leave it?’’, cit.

[473] Throughout history, there exists some examples of breaking-up currency monetary unions, such as Czechslovakia. The Monetary Agreement signed in 1992 envisaged also a provision for abandoning the monetary union. Yet, the conditions were completely different from the ones concerning the Eurozone. The former Czechslovakia adopted a very *ad hoc* coordination - dislocated over a period of time - for limiting both costs and pressure of withdrawal on the banking system and minimizing the dislocation to trade and economic activity. To know more on the dismantlement of Czechslovakia, see B. Eichengreen, ‘’The Breakup of the Euro Area’’, cit. pp. 23-26.

[474] Dismantling the Eurozone or leaving it might not be the right response for regaining competitiveness - it being associated not only to exchange rate misalignment but also internal industrial structure. Internal devaluations might not be the right choice for all the economies and rather, it could have a small impact. For some countries, such as Italy, Spain, Portugal or Greece, the internal structure and their institutions are one of the problems that directly impacts the economy. Moreover, being members of the monetary union, countries with large deficits tend to suffer less in terms of credit rating and inflation effects. Scenario Team Eurozone 2020, ‘’Conference Report: Has the euro been a failure?’’, cit., p. 7.

scenario and avoiding this «muddling-through» condition[475]. The political cost of exiting seems extremely dangerous which could also explain the Eurozone's survival despite discontent and the currency area's ineffectiveness: fear of financial contagion and loss of influence[476].

3.1.2. Minimal conditions for avoiding Eurozone break-up

Problems affecting Eurozone are the result of an inefficient architecture designed for surrounding the Euro. Whether the single currency will survive in the future is surely a question that many countries and leaders are rasing. As a result, two approaches have emerged due the current dissatisfaction and discontent: (1) talking about a real failure and proceed with a substantial reform of the Treaties for improving what has been achieved by far through a better coordination (reflecting the real needs of the countries) and (2) considering seriously options for breaking-up the Euro-area despite risks and costs, which should be amortised through an efficient coordination.

Undoubtedly, the whole project, as it was initially conceived, was doomed to show its inefficiencies sooner or later. When looking at pro and cons of creating a monetary union, the cost was not only in terms of monetary policy loss but also fiscal one. Unsustainable fiscal policies destabilize the entire Euro-area with national fiscal policies having a direct and indirect effect on the Euro-inflation[477].

The 2008 crisis put significant pressure on the Eurozone to the extent that countries suffered both from banking crisis and sovereign debt crisis demonstrating that creating a monetary union is something more than simply sharing a common monetary policy. The European Monetary Union was, indeed, ill-prepared by the time of the crisis to deal with the built-up financial imbalances as it was lacking a supervision mechanism, a crisis management mechanism for addressing the financial crises, followed by a reluctant ECB to activate the QE Programme. A similar situation raised doubts and considerations over a feasible dismantlement of the Eurozone thus threatening the real existence of the Eurozone.

Poor monetary policy decisions and inappropriate fiscal rules contributed to a general instability on the market, a slow resolution of banking problems and finally, an inadequate fiscal policy[478].

---

[475] Monetary unions can help to keep inflation low as inflation rates tend to be much more stable and less volatile than they are used under flexible exchange-rate system. Hence, it helps preserve price stability as in the Eurozone's case. Indeed, inflation rates have been quite stable and lower since the establishment of the Monetary Union. V. Chari, A. Dovis, P. Kehoe, ''Reforming the European Monetary Union'', *Economic Policy Papers*, XVII, III (2017), p. 2.

[476] It is important not confuse the European Union with the Economic and Monetary Union. The Brexit case has somehow given impression that breaking-up is a feasible solution (which should occur on the 29th March 2019). Leaving EU implies losing access to free trade market, customs union, free movement of capital and labour; a revision of a huge amount of legislation and jurisprudence, macro-economic policies and so forth on. Leaving Eurozone implies also the redefinition of the monetary and banking policies. Moreover, there is a major difference in the Brexit case. Firstly, art. 50(1) TEU acknowledges the withdrawal from the Union. Secondly, the United Kingdom was already *an opting-out country* with a different treatment concerning certain fields. Nonetheless, the outcome is still uncertain due to a possibility of a «no deal» and the difficult circumstances the British Prime Minister, Theresa May, is moving in.

[477] S. Wren-Lewis, ''The Eurozone's flaws are not intrinsic'', *Intereconomics*, LI, I (2016), p. 20.

[478] A. Sapir, G. Wolff, ''Euro-Area Governance: What to reform and how to do it'', *Bruegel Policy Brief*, I

Today, minimizing the reality of a Eurozone break-up should be a priority for the EMU member states suggesting that the current «muddling-through» cannot last forever. Rather, a general improvement of the current scenario though a better coordination of the current institutional arrangement is needed. Surely, some progress has been made about banking union but this is still not sufficient for ensuring a long-term stability and preventing further divergences among the Eurozone member states. However, obstacles to political integration confirms the inner limits to further transfer of sovereignty. On the one hand, centralized provision in the banking system have been adopted but on the other hand, fiscal policy is still kept at a decentralized level due to a legitimate resistance as a result of different tolerance of debt, deficits and economic instabilities. Nonetheless, for the Euro to survive and be more stable in the long-term, further and better well-designed provisions will be a necessity[479].

Since the establishment of the EMU, many barriers to movement have been removed thanks to the Schengen Agreement (1985) and the creation of the Single Market (1986). Yet, stabilization mechanisms for preventing asymmetric shocks are lacking: labour mobility is still low while European budget is small (less than 2%)[480]. Even though the Growth and Stability Pact (GSP) has been revised through the adoption of additional reforms, they mainly focus on public debt and structural deficit limits while giving relative importance to a more adequate macroeconomic surveillance, sustainability of welfare system and relaunching of both growth and prosperity[481].

To worsen this situation, there are not efficient mechanisms for providing fiscal transfer from one country in difficult times to the other when confronted with a tough moment. What the Eurozone needs is surely a mechanism for providing a more efficient coordination and regulation of economic divergences and fiscal policy being the latter decentralized and labour mobility limited.

(2015), pp. 1-2.

[479] B. Eichengreen, C. Wyplosz, ''Minimal Conditions for the survival of the euro'' in R. Baldwin, F. Giavazzi (edited by) *How to fix Europe's monetary union,* London, CEPR Press (2016), pp. 34-36.

[480] The ECB highlighted that since the crisis, unemployment conditions have not changed enormously. Hence, it stressed the need to adopt concrete structural policies to improve labour market, its functioning and finally, boost economic growth and competitiveness. Measures should focus on improving labour quality; providing a well-functioning and effective wage setting system, especially concerning minimum wages and finally, increasing working flexibility to facilitate transition and changes within labour market. Eurozone labour market is, indeed, still slacking and weak while wage growth is still feeble. Moreover, the ECB highlights that co-movement and labour mobility, in general, have collapsed since the recovery from the crisis stressing that the degree of labour market efficiency is very low. Structural reforms of the current system are absolutely needed to promote labour productivity growth, efficiency skills and mobility so that European citizens might benefit from a higher prosperity and economic growth and better resources allocation. European Central Bank, ''Updates on economic and monetary development'', *Monthly Economic Bulletin,* III (2017), pp. 30-34.

[481] One of the main problems in the current fiscal scenario surrounding the Eurozone countries is the fact that macroeconomic surveillance focuses mainly on countries with low competitiveness and high deficits (Italy) while disregarding the same importance to the high surplus countries (Germany). In particular, even though the European Commission is entitled to provide *ad hoc* recommendations for which measures should be adopted within the country, they are not decreasing the persistent economic divergences among the Eurozone countries with regards to growth, investment and employment rates. Team Eurozone 2020, ''Future Scenario for the Eurozone: 15 Perspective on the Euro Crisis'', cit., p.6.

The Euro crisis itself demonstrated that the enthusiasm for creating a single common currency and binding countries within a unique EMU was not sufficiently accompanied by effective institutions and measures to cope with crisis and shocks.

Provisions to address price divergences and demand management, indeed, have never been adopted. Two main factors have surely contributed to the build-up of the Financial Crisis in the Eurozone: (1) the enormous economic, social and political differences and (2) an inadequate economic framework and governance able to respond to instabilities and fragilities.

Being the current monetary union composed of different identities and histories, which almost automatically imply a different preference and approach for both monetary and fiscal policy, a reform of governance would be highly desirable.

The ECB's monetary policy does not correspond to the optimum choice for the internal economic conditions of a country where the only feasible response can occur through fiscal policy, which is in any case bound to the Stability and Growth Pact, thus limiting a government's action. Indeed, the current 3% deficit-threshold limits the room for manoeuvre for applying countercyclical fiscal policy[482].

Hence, reforms in the current fiscal and economic framework are necessary for preventing any further crisis and ensuring, in the long-term, stability, prosperity and competitive growth but also, for overcoming free-rider problems and excessive debts and deficits. At the moment, an efficient mechanism for monitoring Euro-area fiscal stance and policy distribution is lacking while risk-sharing is not adequately redistributed among the Eurozone countries.

Similarly, competitiveness problems frequently occur among the Euro-countries as there exists only very feeble mechanisms, which are applied in a very asymmetric case: the Macroeconomic Imbalance Procedure (MIP) and the Euro Plus Pact[483].

---

[482] B. Eichengreen, ''The Breakup of the Euro Area'', cit., pp. 38-42.

[483] In 2011 through Regulation No 1176/2011, European leaders decided to adopt a Macroeconomic Imbalance Procedure (MIP) as part of the ''Six Pack reforms'' to identify, prevent and address potentially harmful imbalances in terms of large deficits. The MIP is built asymmetrically as different threshold are adopted whether the country face an external surplus (+6%) or a deficit (-4%). Even though, according to the regulation, the MIP recommendations should «take into account differences in the way Member States organise their own policy frameworks, with specific reference to collective bargaining, wage formation, and certain welfare state policies», they are done with the primary aim of ensuring macroeconomic surveillance. The coordination of fiscal policies was actually limited to the attempt of preventing countries from entering into an unsustainable fiscal path, rather than ensuring a coordination of price and wages for ensuring a fair and efficient competitiveness. A sort of progress has been done with the Euro Plus Pact, in 2011, which grew out of a Franco-German proposal. European countries decided to stipulate a pact according to which wages should evolve in line with productivity with the aim of ensuring both convergence and coordination of competitiveness. Unit-labour-costs are thus monitored and compared with the developments in other Euroarea-countries. Nonetheless, it has been enormously criticised for being excessively focused on differences in price competitiveness as it aims at reducing both financial and economic imbalances rather than ensuring a real coordination. A. Bénassy-Quéré, X. Ragotb ''A Policy Mix for the Euro Area'', *Conseil d'analyse économique,* XXI (2015), pp. 1-3, p. 6.

Most decisions concerning wage-setting are taken nationally by individual countries even though *an open method coordination* is adopted to promote a safer economic policy coordination for convergence. However, financial imbalances and nominal divergences persist as they focus on wrong targets by attacking ‘’the messengers’’ of the economic imbalances. Focusing on the real causes could prevent increasing current account imbalances[484].

Reforms in some key areas could help improve the overall scenario: (1) completing the Banking Union as a proper institutional response for banking-system stability, even though European banking and financial system is fairly integrated, especially since 2012; (2) Completing the Capital Market Union (CMU); (3) creating an appropriate system for providing adequate financial resources in case of shocks and crisis; (4) ensuring a more solid fiscal stance by adopting efficient macro- and micro-prudential policies, allowing also countercyclical policy, ignored by the Stability and Growth Pact (SGP)[485]; (5) the creation of a solid Single Economic Market; (6) transforming the European Central Bank into a real democratically accountable and transparent bank, less focused on inflation and more on an appropriate two-pillar strategy[486] and (7) creating a debt restructuring and mutualisation mechanism.

---

[484] The chief target in the Euro Plus Pact is the development of competitiveness by looking at changes in the labour-unit-costs. Deteriorating costs and price competitiveness are one of the real sources of financial instability. However, Euro Plus Pact does not take into consideration the fact that capital flows lead to changes in terms of competiveness, as it happened in the case of both Spain and Ireland that underwent a real boom (and bubble). Developments in the labour units costs are, indeed, partly influenced by capital flows. Large capital inflows might cause an upward pressure while large capital outflows can cause a downward pressure on the relative labour costs. Basically, restraining growth in unit labour costs through the Euro Plus Pact might not be the right approach for influencing the current account imbalances in the long-term. H. Gabrisch, K. Staehr, ‘’The Euro Plus Pact Cost Competitiveness and External Capital Flows in the EU Countries’’, *ECB Working Paper Series*,(2014), pp. 2-3; pp.

[485] Since the launching of the Maastricht Treaty and the Stability Growth Pact (SGP), a series of reforms under Six Pack, Two Pack, European Semester, have been launched in an attempt to centralise European fiscal policy. Yet, none functions properly as Eurozone member states have different preferences and approaches to fiscal policy management. Surely, instability in one country can create spill-over effects in another one but fiscal centralization might not be the solution for the European Economic and Monetary Union as fiscal policy operates as a stabilization mechanism in the absence of an autonomous monetary policy. B. Eichengreen, C. Wyplosz, ‘’Minimal Conditions for the survival of the euro’’, cit. pp.40-41.

[486] The European Central Bank’s mandate focuses on a two-pillar strategy: price stability by keeping low inflation and a growth determined by monetary aggregate. By introducing a target of less but close to 2%, ECB’s monetary policy negatively impacts the economy creating a deflationary pressure. ECB is affected by three main problems indeed: (1) excessive fear of inflation that leads it to commit mistakes in raising interest rates, (2) fear of buying government debt which brought delays in activating the QE and (3) an obsession with the need of austerity, as Troika showed. Surely, the Big Crisis has already contributed in transforming the ECB into a more real bank. However, still a significant problem is represented by the fact that there is no government in the Euro-area able to contrast decisions taken by the ECB that have affected some countries more than others in time of crisis. More transparency would help enhance Euro’s survival as monetary policy would be taken focusing on the Eurozone common good. Likewise, more public accountability would be necessary, even though the ECB holds already occasional briefings to the EU Parliament. S. Wren-Lewis, ‘’The Eurozone’s flaws are not intrinsic’’, cit., p. 23.

However, also proposals for implementing transfers among Eurozone member states should be taken into consideration as way for improving internal economic conditions and making the general situation more stable. Unquestionably, the Eurozone needs to adopt a mechanism for addressing misalignments in terms of competitiveness and productivity among the member states, for example by adopting a regular assessment and definition of instrument. These should be corrected before they become a serious problem for the whole monetary union. Similarly, the MIP should be applied symmetrically not by focusing only on the excessive deficits while decisions taken nationally, especially wage negotiations, should be taken considering also the impacts at Euro-level[487].

Likewise, the current ineffective fiscal framework should be revised and better conceived. Whether it should be further implemented or completely decentralized is surely a question of debate. Nonetheless, what is clear is that the current system is not perfectly working. Mechanisms for further correcting and addressing moral hazard should be introduced and similarly, more attention to unsustainable debt levels should be warranted. More reasonable and solid fiscal stance would be guaranteed while providing a more efficient and effective fiscal surveillance.

Undoubtedly, the introduction of new procedures and mechanisms would request both a political solidarity and support that are nowadays trembling. Surely, resistance to further steps for political integration might occur. However, in order to establish a well-functioning monetary union, fiscal mechanisms for addressing shocks are needed to benefit from prosperity, growth and employment.

PART TWO

Strengthening Eurozone framework: Preserving financial stability

3.2. Completing the Banking Union: Creating a European Deposit Insurance Scheme (EDIS)

The sovereign debt crisis that hit the Eurozone revealed both unpreparedness and incompleteness in the European monetary and banking framework. By the time, the available measures were insufficient to stop and prevent a self-fulfilling crisis. Since 2012, several mechanisms have been adopted by launching the transformative European Banking Union program with the aim of improving Euro-Area capacity and stability given the importance of bank-financing in the European economy.

The crisis, indeed, revealed that the banking system stability should be a priority for both European interbank markets and the related mechanisms. A well-functioning and safe banking sector is an absolute requirement for both stability and resilience in the Eurozone. As a result, on an *ad hoc* legal

[487] National wage-setting systems are a direct outcome of a nation's history and its social roots. Nonetheless, it is one of the elements that contributes the most to divergences and misalignments within the Eurozone since they directly impact the real-exchange rates. Within a monetary union, deviations of wage growth from labour productivity raise question of adjustments. Therefore, decisions taken in one Eurozone country should be conformed with the Eurozone membership so as to avoid real-exchange-rate misalignments and problems in competitiveness. Eurozone, indeed, cannot continue to move along this heterogeneity in the labour market. A. Sapir, ''The Eurozone needs less heterogeneity'', in R. Baldwin, F. Giavazzi (edited by) *How to fix Europe's monetary union*, London, CEPR Press, 2016, p. 180-185.

basis, a system of banking supervision to prevent systemic crisis, under the Single Supervisory Mechanism (SSM), and a mechanism for restructuring problematic banks in difficult moments, under the Single Resolution Mechanism (SRM), have now been centralized[488]. Both institutions have surely contributed to improving Eurozone resilience, increasing risk-sharing and quality bank oversight while providing crisis management, especially in the case of Greece[489].

Nonetheless, the Banking Union should be further implemented and completed with additional measures and provisions for breaking the loop that still binds Eurozone governments and banks[490]. The current half-designed Banking Union still leaves Eurozone exposed to idiosyncratic risks and shocks that could still impact assets, investments, the stock market and in general, the Eurozone's survival in case of another financial crisis.

A Banking Union does not only entail banking supervision but also uniform procedures, which have been already adopted under the «single rulebook» and lastly, a common deposit insurance scheme[491]. Hence, the completion of the banking union might be the key factor for ensuring further financial stability and setting better conditions for economic framework.

---

[488] The Single Supervisory Mechanism (SSM) was established upon art. 127(6) TFEU, which allows to confer specific tasks to the European Central Bank on «prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings». Hence, the SSM is attempting to reduce the feasibility of bank failures by applying a more uniform and strict banking regulation to avoid capital and liquidity shortfalls while pushing banks to cope with non-performing loans (NPLs). On the contrary, the Single Resolution Mechanism (SRM) is founded upon art.114(1) TFEU, which confers powers with the goal of providing a well-functioning internal market by reducing failures in coordination and enforcing more efficient and effective common rules and uniform resolution. G. Claeys, ''The missing pieces of the Euro architecture'', cit., pp. 4-5.

[489] The Single Supervisory Mechanism (SSM) has intervened by limiting Greek bank-exposures to Greek government. Even though a similar approach has been criticized since it has added further pressure on the Greek government for reaching an agreement with its creditors, it has actually contributed to improving Greek banking system's resilience, despite political instabilities. Furthermore, this measure has augmented liquidity provisions for Greek banking system in case of a default being banks less exposed to government. Limits on bank-exposures were a necessary condition for two reasons: (1) allowing Greece to have access to ECB's liquidity for avoiding a government default and (2) increasing Eurozone stability and resilience for avoiding Greek exit. N. Véron, *Europe's Radical Banking Union,* Brussels, Bruegel Essay and Lecture Series, (2015), pp. 5-8.

[490] The Eurozone crisis revealed not only a tight link between governments and banks, but also the predominance of bank-financing across Europe. Governments were badly hit and had no choice but to increase bank's financing costs leading to an inevitable vicious circle. Weak banks depressed Eurozone economies that further undermined governments and banks. D. Gros, ''Completing the Banking Union'', in R. Baldwin, F. Giavazzi (edited by) *How to Fix Europe's monetary union,* London, CEPR Press (2016), pp. 87-88.

[491] The Single Rulebook aims at providing a set of harmonised rules for the financial-banking sector to make it more transparent, efficient and resilient among depositors, supervisors and investors. Three main legislatives acts thus define the single rulebook: (1) Bank Recovery and Solution Directive (Directive 2014/59/EU); (2) Capital Requirements Regulation and Directive (Directive 2013/36/EU), which implement Basel III capital requirements (4.5% of common equity) and (3) Deposit Guarantee Scheme Directive (Directive 2014/49/EU), which regulates deposit insurance in case of bank failure.

Banking Union results as an incomplete project as some critical and important issues are still left apart: (1) the concentration of sovereign debt by banks with a low risk-sharing mechanism, even though some progress has been achieved for breaking the sovereign-bank loop[492]; (2) the absence of a European Deposit Insurance Scheme (EDIS) since deposit insurance is still kept at a decentralized and national level and (3) a supervision limited to significant and systemic banks[493].

Keeping the Deposit Insurance at national level is in contrast with the concept of a European banking union risking to create contagions from a fragile banking system to a sovereign debt[494]. Having both the Single Resolution Mechanism (SRM) and Single Supervision Mechanism (SSM) a different nature, the creation and launching of a European Deposit Insurance Scheme (EDIS) is a necessary component for completing the Banking Union.

In 2014, the European Commission adopted the Directive 2014/49/EU to protect depositors' savings and deposits withdrawal in case of bank failures. Even though it prevents bank runs and protects bank depositors from the inability of a bank to repay back its debt, it is still not sufficient[495].

The creation of a fully integrated deposit insurance would be a right response to ensure further stability and risk-sharing within the monetary union and break the vicious circle between banks and sovereign[496]. Despite the legislative proposal of the European Commission for a creation of an

---

[492] On average, Eurozone bank-holdings on sovereign amount up to around 140% with the exception of Italy, Germany and Belgium, with bank holdings amounting up to 200%. A similar situation still raises the risks of reoccurrence of a sovereign debt crisis, should investors lose confidence over a Eurozone member's debt sustainability. S. Micossi, ''A blueprint for completing the banking union'', *CEPS Policy Insight*, XLII, XI (2017), p. 3.

[493] Less-significant and small banks are not supervised on an on-going basis by the European Central Bank. Rather they still remain fragile and fragmented raising doubts over the credibility and the effectiveness of the ECB banking supervision and monitoring. On the contrary, banks are classified as significant on the basis of several criteria: (1) size (total value of assets exceeding 30 billion euros); (2) economic importance (for the country and the whole euro-area); (3) cross-border activities (total value of assets exceeding 5 billion euros) and (4) direct public financial assistance (whether it has received assistance from the ESM). A. Bénassy Quére and co., ''Reconciling risk-sharing with market discipline: a constructive approach to euro area reform'', *CEPR Policy Insight*, XCI, I (2018), p. 6.

[494] Without the establishment of a European Deposit Insurance Scheme (EDIS), confidence and trust in the banking system might be strictly dependent on sovereign creditworthiness. Hence, a similar mechanism could contribute to provide stability and crisis management. Furthermore, keeping a centralised supervision with a decentralised national insurance deposit might be dysfunctional as national deposit insurances would have to cope with problems that might be caused by an inefficient European supervision. M. Demertzis, G. Wolff, ''What are the prerequisites for a euro-area fiscal capacity?'', *Bruegel Policy Contribution*, XIV (2016), p. 6.

[495] In November 2015, the European Commission proposed the creation of a European Deposit Insurance Scheme (EDIS) under the Directive 2014/49/EU. Even though some minimum standards have been already achieved at EU level - 100.000 euros guaranteed to every single depositor - deposit guarantee schemes are still kept at national level. Indeed, what might happen in case of bank failure and inability to cover depositor losses through national schemes is that shortfalls would be inevitably covered by taxpayers damaging automatically also the country. European Commission, European Deposit Insurance Scheme, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/european-deposit-insurance-scheme_en, consulted on the 15th November 2015.

[496] The Single Resolution Mechanism (SRM) ensures bank restructuring so as to avoid a failure and prevent any

efficient integrated EDIS by 2024, sufficient consensus is lacking. Hence, besides a deadlock and a lacking progress in the policy discussion, the current EDIS involves no debt-mutualisation and risk-sharing, which continue to fall on national insurance scheme[497].

A well-functioning EDIS would spread confidence and financial stability in the whole monetary union and reduce bank exposures to sovereign debt for two main reasons. Firstly, a deposit insurance enhances trusts in bank deposits, if considered credible, while reducing bank funding costs and bank runs providing major stability. Secondly, the adoption of a European Deposit Insurance Scheme would improve crisis-management within the monetary union and fulfil the main objective of the banking union: decoupling banks from sovereign debt[498].

Reducing the link between banks and sovereign debt to prevent further crisis and also the stock of non-performing loans (NPLs), which depresses banks profitability and prevents an efficient transmission of the monetary policy, shall be the main priority for the creation of a Banking Union.

Great results have already been achieved through the SSM. Yet, reducing banks holdings sovereign bonds is necessary for two main reasons: (1) the impact over banking and sovereign markets and (2) the provision of liquidity in the financial markets[499].

---

damages or instability in the real economy. The SRM aims at implementing a resolution with minimal costs both for taxpayers and economy by avoiding insolvency and harmful contagious effects. The SRM attempts to enhance the continuity of those bank's functions that are considered of systemic importance. On the contrary, the Single Supervision Mechanism (SSM) assesses risks (in terms of geopolitical challenges and difficulties) and pays attention to non-performing loans (NPLs) being a distinctive feature of European banks' balance sheets. European Commission, Single resolution mechanism, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/single-resolution-mechanism_en, consulted on the 14th November 2018; European Central Bank Banking Supervision, Risk Assessment, https://www.bankingsupervision.europa.eu/banking/priorities/risk_assessment/html/index.en.html, consulted on the 14th November 2018.

[497] See. European Commission, ''Proposal for a Regulation of the Regulation of the European Parliament and the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme'', COM(2015) 586 final [2015].

[498] Centralising European banking supervision while keeping decentralised national deposit insurance scheme risks to create a destabilizing effect by fostering the bank-sovereign loop. Insolvency of a government could directly influence trust and confidence in banks as the only available financial backstop for national deposit insurance schemes would rely on national budgets. G. Claeys, ''How to build a resilient monetary union? Lessons from the Eurocrisis'', cit., pp. 14-15.

[499] The stock of non-performing loans (NPLs) still amounts at 800 billion euros and it is mainly concentrated in Portugal, Italy, Cyprus and Greece. A similar situation not only creates a great instability but it also influences the correct transmission of monetary policy. As a result, the Single Supervisory Mechanism (SSM) released a ''Guidance on non-performing-loans'' in March 2017. This stressed the need of «an ultimate reduction of NPLs stocks in a clear, credible and feasible manner for each relevant portfolio» devising an appropriate strategy that includes externalities, the operating environment, changes in bank structure and bank management. ECB Banking Supervision, ''Guidance on non-performing-loans'', (2017) pp. 8-9.

Some major concerns involve treatment of deposits, in case of bank failures and financial crisis. Banking Union is, indeed, incomplete for the fact that both national governments and national deposit insurance schemes are still the backstops for banks[500].

The creation of a European Deposit Insurance Scheme is indispensable for completing Banking Union and integrating more the financial market through risk-sharing. This strategy would reduce funding conditions that still depend on bank locations, market fragmentation and expectations of financial crisis[501].

By launching EDIS, recurrences and expectations of liquidity crisis turning into a sovereign crisis, would be almost eliminated. EDIS would intervene promptly as a credible safety net and a credible protection against liquidity crisis in case of a significant shock (bank failures and defaults). Advantages would come also for depositors that would be treated equally since national banking risks would disappear. Hence, market fragmentation would be significantly reduced while private risk-sharing would increase[502].

The Eurozone crisis demonstrated that a deposit flight is very difficult to stop, as it occurred in Spain, Ireland and Greece. Since the market doubted whether those countries were in a strong position to support their banking system, they were seriously hit by the banking crisis that gradually spread.

Being in a more quieter moment, it is important to create mechanisms for safeguarding the banking system from threats of systemic crisis. The creation of a European deposit insurance might be the solution, as also the USA banking union did in the past[503].

Deposit insurances should act in such a way that they minimize bank-exposures of governments as fiscal backstop. In order to ensure a well-functioning EDIS, non-performing loans (NPLs) in banks should be completely removed by setting up a very specific policy package: (1) the introduction of sovereign concentration charges for banks and common deposit insurance, since the European Commission's Proposal lacks any regulatory treatment over sovereign exposures and (2) a better

---

[500] D. Schoenmaker, G. Wolff, What options for European deposit insurance, http://bruegel.org/2015/10/what-options-for-european-deposit-insurance/, published on the 8th October 2018, consulted on the 22nd November 2018.

[501] One of the main problems in the current European Banking Union is related to the fact that deposit guarantees are still kept at national level with deposit rates varying across the Eurozone-countries. As a result, bank locations still determine the degree of risk for bank-deposits. D. Schoenmaker, G. Wolff, ''What options for European deposit insurance?'', cit.

[502] S. Micossi, ''A blueprint for completing the banking union'', cit., p. 9.

[503] Following the Great Depression (1929), during which deposit insurance funds went bankrupted, the US President Franklin Roosevelt opted for the creation of a deposit insurance system at federal level, in 1933. The Federal Deposit Insurance Corporation (FDIC) is now entitled with preserving and enhancing public confidence in the US financial system, protecting deposits in banks through monitoring, readdressing risks to the deposit insurance funds and containing effects and damages on the real economy. Hence, the FDIC conducts supervision over 4000 banks and fulfils brilliantly its tasks in protecting depositors. Since its establishment, no depositor has lost neither funds nor deposits. Federal deposit insurance corporation, https://www.fdic.gov/about/learn/symbol/index.html, updated on the 5th March 2017, consulted on 22nd November 2018.

accounting and supervision by the European Central Bank for these loans in bank balance sheets to ensure their volume reduction[504].

EDIS and a risk-sharing mechanism could be set up only through intricate political compromises and negotiations that require trust, legitimacy and accountability. Yet, it could be economically beneficial provided that funds are adequate to conditions.

Political rejections, especially on behalf of Germany, have already come to light for two reasons: (1) some countries, i.e. Italy, Spain or Greece, could take advantage and abuse of the fund withdrawing liquidity and (2) the third pillar of Banking Union touches the fiscal dimension of the banking sector (in terms of fiscal backstop). Nonetheless, similar considerations can be overcome on three assumptions: (1) financial and banking stability, being both intertwined, is a necessary condition in the Eurozone; (2) in order to implement banking union, well-designed rules and provisions must be adopted for avoiding liability, risks and further destabilizing effects and (3) the need of a new EU legislation to eliminate the geographical «ring-fencing» of national capital liquidity. The latter prevents the rise of cross-border banking groups in the area[505].

By sharing risks while breaking the sovereign-bank circle, systemic crisis risks (caused by incautious fiscal discipline and policies) might decrease.

The creation of a European Deposit Insurance System would have the essential function of injecting trust and depositor's confidence in the Eurozone financial system. It would provide further stability and improve crisis-management while decreasing moral hazard. In addition to, specific measures might be introduced: (1) the introduction of limits over banks' concentration in the government bonds for reducing sovereign risks in balance sheets; (2) shares-reduction for non-performing loans (NPLs) so that banks enter completely clean in the EDIS; (3) the creation of a bank- and country-risk-based-premium or risk-based fee, funded by national deposit insurances, which will be higher for country with weak and feeble banking policies, thus creating incentives for better rules[506]; (4) the creation of a re-insurance phase for depositors, which will furnish a liquidity credit-line for liquidity shortfall in national deposit guarantees schemes (DGS)[507].

---

[504] I. Schnaebel, N. Veron, Breaking the Stalemate on European Deposit Insurance, Bruegel, http://bruegel.org/2018/03/breaking-the-stalemate-on-european-deposit-insurance/, published on the 5th March 2018, consulted on the 9th December 2018.

[505] B. Eichengreen, C. Wyplosz, ''Minimal Conditions for the survival of the euro'', cit., pp. 38-39.

[506] Despite progress in completing the Banking Union, still differences among the European nations would persist affecting banks' business models such as taxation, housing finance, insolvency and so on. As a result, as the EC 2015 Proposal stresses «EDIS would be privately funded through ex ante risk-based fees paid by all the participating banks in the Member States and devised in a way that would prevent moral hazard». Therefore, there would be a fee differentiation in terms of bank risks profiles. European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, COM(2015) 586 final [2015], pp. 55-56.

[507] D. Schoenmaker, Building a stable European Deposit Insurance Scheme, https://voxeu.org/article/building-stable-european-deposit-insurance-scheme, published on the 17th April 2018, consulted on the 22nd November 2018.

Considering fee differentiation, several parameters might be introduced taking into account the quality of the country's legal framework, creditor protection and a structure requiring cost of pay-outs linked to bank failures in case of shocks, where EDIS system would contain national impact. On the contrary, for country-level differentiation, sound incentives would be offered to banks to decide where and how to operate, through a subsidiary or a branch, while accommodating diversity of Eurozone banking structure[508].

Surely, the creation of the third pillar raises three important problems: (1) political and democratic accountability; (2) a possible change in the surrounding political and legal framework by focusing on bank insolvency legislation, banks' health and state of balance-sheets sand (3) problem of moral hazard as participating countries might be less strict in banking policies. Yet, it could be overcome through a tough banking supervision, limitation of banks' sovereign holdings, reduction of NPLs and the introduction of a risk-based premium[509].

A good deposit insurance in line with the current treaties - upon art. 114 TFEU which allows the adoption of new measures for internal market functioning - might work as a mechanism for providing further stability, liability and control while improving banking union. Besides ensuring risk-sharing and market discipline, a well-functioning EDIS would prevent bank-runs by protecting depositors' vulnerability from local shocks while reducing redenomination-risk (being deposits guaranteed up to a certain amount)[510].

---

[508] In managing distress in the financial system, adequate protection of depositors must be ensured. Hence, depositors are protected by national Deposit Guarantee Scheme (DGS) that ensures that deposits will be repaid until a certain amount, even in case of bank default. Surely, the EU system has been strengthened. Banks must pay a tax every year into a national DGS fund which is used if the DGS needs to protect depositors. In addition to, even though the level of depositors in the EU is harmonised up to 100000 euro, still a number of differences persist considering the national DGSs. Fourteen countries' deposits are covered by one single national deposit insurance. These are: Belgium, Estonia, Finland, Greece, France, Ireland, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Slovakia, Slovenia and Spain. On the contrary, Austria has five separate deposit insurance schemes: (1) For the Austrian Commercial Banks; (2) for the savings bank sector; (3) for the Raiffeisen sector; (4) for the regional mortgage banks and (5) for the Volksbank sector. Germany has four: (1) for German Private Banks GmbH; (2) for German Public Banks GmbH; (3) for German Savings Banks association and (4) for cooperative Banks GmbH. Finally, two deposit insurance schemes can be found in Cyprus (one for cooperatives banks and the other for CCIs); in Italy (one for Credit Cooperative Banks and one for the Interbank Deposit Protection) and in Portugal (one for Mutual Agricultural Credit Guarantee fund and one for banks). EBA, Deposit Guarantee Schemes data, https://eba.europa.eu/regulation-and-policy/recovery-and-resolution/deposit-guarantee-schemes-data, consulted on the 9th December 2018.

[509] One of the main problems in creating the European Deposit Insurance System (EDIS) would be the definition of a legitimate political and legal authority entitled to head the new institution whether the European Parliament or a new institution that should represent European and national interests. Surely, it might create politically problems at EU level. M. Demertzis, G. Wolff, ''What are the prerequisites for a euro-area fiscal capacity?'', cit., p. 7.

[510] Several are the proposals on how EDIS might be established and which specific tasks should it cover. The European Commission envisaged a three-stages system: (1) *a reinsurance scheme* for national Deposit Insurance Scheme (DGSs) in a period of three years by providing «limited funding, and covering a limited share of the loss»; (2) *a co-insurance scheme* for DGS in a second phase of four years where EDIS would «

Theoretically speaking, Euroarea countries might benefit from the system. Indeed, also small banks would be monitored by introducing sovereign concentration charges to reduce sovereign-bank loop[511]. Surely, the creation of an efficient EDIS requires an elaborate transitional phase, which should occur in a period of five-ten years and where the legislative process could see further progress only after the election of the European Parliament, in 2019.

3.2.1. Launching a European Monetary Fund (EMF)

By the time of the crisis, several mechanisms were introduced to put an end to the instabilities in the government bond markets and banking system which put an enormous pressure on the Eurozone. Two instruments contributed the most to the significant institutional developments in the resolution of the Eurozone crisis: (1) the launching of the Outright Monetary Transactions (OMT) and the Securities Market Program (SMP) by the European Central Bank, which provided an indispensable safety net and (2) the establishment of the European Financial Stability Facility (EFSF) then transformed into the European Stability Mechanism (ESM)[512].

Surely, great results have been achieved. On the one hand, the OMT helped guide instable markets toward a good equilibrium. By acting as a lender of last resort for the Eurozone sovereigns, the ECB reintroduced a well-functioning transmission of monetary policy. On the other, the ESM provided financial assistance to those countries in need of recapitalization. Nonetheless, the access to the OMT was warranted provided that a Eurozone country participated in the ESM program and its debt is sustainable[513]. Hence, many fragilities are still present while Eurozone economic governance is highly imperfect for three main assumptions: (1) debt sustainability must be technically assessed; (2) a political agreement and approval of debt sustainability is necessary under unanimity thus procrastinating decisions that should be quickly taken for preventing full-blown crisis and (3) the ESM

---

cover in a second step also 20% of the participating DGS's excess loss and […..] reaching 80% in the last year of the coinsurance» and (3) *a full insurance for the national DGS*, «with EDIS covering a share of 100%». In all three stages, EDIS would provide funding while covering losses of participating DGS or providing resolution of a failing banks. European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, COM(2015) 586 final, [2015] pp. 9-12.

511 Considering the functioning of EDIS, also small banks should be controlled by the SSM. Indeed, they are not supervised at European level but by national competent authorities, according to Art. 6(4) of the SSM Regulation and Art. 39 of the SSM Framework Regulation. Small banks or Less Significant Institutions (LSIs) contribute as well to the sovereign-bank loop being their activities less diversified across Eurozone countries and keeping a more domestic dimension. Therefore, also the LSIs should be properly reviewed both by the ECB and European authorities within EDIS. I. Schnabel, N. Veron, ''Breaking the stalemate on European Deposit Insurance'', cit.

512 A. Sapir, D. Schoenmaker, ''The time is right for a European Monetary Fund'', Bruegel Policy Brief, IV, X (2017), p. 2.

513 P. De Grauwe, Y. Ji, ''How to reboot the Eurozone and ensure its long-term survival'', in R. Baldwin and F. Giavazzi (edited by) *How to fix Europe's monetary union,* London, CEPR Press, 2016, cit., p. 145.

and OMT program solve only self-fulfilling liquidity crisis while lacking instruments for an insolvency crisis[514].

To have access to the OMT program, the ECB needs to examine whether a country is facing a liquidity or a solvency crisis. Only in this case, the ECB is allowed to intervene in contrast to the insolvent case, which would raise a political conflict that the monetary authority cannot undertake. Therefore, the credibility of the OMT is quite limited as it does not function as an insurance mechanism, it being subject to the assessment and evaluation of the ESM. Its main purpose was, indeed, to ensure both credibility and stability in the Eurozone rather than substituting the ECB[515].

Even though the ESM has significantly evolved since its establishment, major provisions should be adopted for transforming the monetary union into a more resilient and solid area and building more efficient crisis management tools[516].

Eurozone countries have taken for granted that the ECB will continue providing liquidity for ensuring the Euro survival, in case of another financial crisis. Yet, due to its initial reluctance, the intervention might have been only of temporary nature. Hence, since the current framework is incomplete for containing further crisis, significant and comprehensive changes should be adopted[517].

---

[514] The European Stability Mechanism (ESM), created for providing financial assistance to Eurozone countries facing financial problems and instability, provides three main facilities: (1) *ex-post conditionality*, i.e. lending to Euro-area governments in exchange of adjustments; (2) *ex-ante conditionality*, i.e. financial assistance based on credit-lines provided that specific conditions are met and (3) *lending for bank-recapitalisation*. Lastly, the OMT allows the ECB to buy government bonds in the secondary market aimed «at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy». A. Sapir, D. Schoenmaker, ''The time is right for a European Monetary Fund'', cit. p. 3.

[515] D. Gros, T. Mayer, ''A European Monetary Fund : Why and How?'', *CEPS Working Document*, XI (2017), p. 1

[516] Unquestionably, the European Stability Mechanism (ESM) has matured significantly. First of all, it assumed the role of the initial EFSF which in 2010 was conceived as a *temporary instrument* to inject money and provide loans. Now, it stands as a *permanent mechanism* with a questionable success (the five countries receiving ESM loans suspended them, with Greece only on the 20th August 2018). Secondly, the ESM is much more involved in evaluating financial aspects, monitoring the ability of a country to repay back its debt (liquidity assesment, medium-term sustainability of the debt and market access) and detecting loan repayment risks through the Early Warning System (EWS). Lastly, reliance and dependence on the IMF has reduced over the years. Initially, it was needed due to the IMF's advanced experience in providing financial assistance programmes. (At the beginning of the crisis, one third of the loans were provided by IMF and only one tenth in the second Greek's package).

[517] Public debt crisis are mostly caused by two factors: (1) profligacy (overspending) by the government and (2) a financial boom-bust cycle that might lead to a deep recession and a bank-bailout. Following the financial crisis, the Bank Recovery and Resolution Directive (Directive 2014/59/EU) established that a high level of public sector support (corresponding to 8% of the balance sheet) can be bailed in before involving the public sector. Hence, the occurrence of future financial crisis due to public finances should be reduced. Moreover, also the Single Resolution Fund (SRF) would reduce the need of national governments to provide financial support through their fundings in case of bank restructuring. As it is stated at point(78) in the Regulation (EU) No 806/2014 OJ L 225/1 [2014], «Where the losses cannot be passed to other creditors, the Fund may make a contribution to the institution under resolution subject to a number of strict conditions including the requirement that losses totalling not less than 8 % of total liabilities including own funds have already been absorbed, and the funding provided by the Fund is limited to the lower of 5% of total liabilities including

The case of the Eurozone crisis is very emblematic as it proved two main things: (1) how hard it is to distinguish between a solvency and liquidity crisis and (2) governments might feel the need of a bailout despite political costs for creditors and debtors, in case of unstable financial markets. As a result, to contain risk-contagion, the Banking Union and the Single Resolution Fund (SRF) have been launched, even though resources are limited.

In order to prevent any further financial instability, the Banking Union shall be supported by a fiscal backstop and a stability mechanism that ensures that a bailout will be avoided in the future.

Ensuring a more resilient economy and more solid structure while promoting financial integration would be sufficient for ensuring private risk-sharing, which is still less efficient compared to other monetary union as the United States. On the contrary, concerning the public sector, creating a macroeconomic stabilization without providing permanent transfer seems a suitable response.

Reinforcing the current European Stability Mechanism (ESM) – by extending its competences and tasks and transform it into a European Monetary Fund (EMF) - could be helpful in preventing further crisis, ensuring financial stability among the Eurozone countries while limiting the negative spill-overs from the Euro-country in difficult to the other member state and lastly, reducing the need to rely on the ECB in maintaining the EMU[518]. A similar mechanism should be not intended to punish countries in an attempt to impose fiscal discipline but rather as an instrument for distributing efficiently responsibilities and establishing sound public and private finances. European countries would not bear the cost of the excessive debt accumulation of the other irresponsible countries. The financial stability mechanism would respect and reinforce the principle of no-bailout.

The EMF should create the conditions to decide whether to financially support a country due to market loss and where a debt restructuring should be granted, whenever an adjustment programme does not work and debt is excessive and unsustainable. As a result, a better crisis management tool for acting

---

own funds or the means available to the Fund and the amount that can be raised through ex-post contributions within three years».

[518] The five programmes that were launched under the ESM are described as a real «success». Portugal, Ireland and Cyprus's financing difficulties were temporary while Spanish banking recapitalization was not so costly. Nonetheless, the ESM programmes were criticized for being extremely harsh, even though the financing avoided three defaults. Undoubtedly, the political cost has been excessive as ESM programs are not remembered for having avoided both insolvency and financial collapse but rather for austerity and costs in terms of incomes, unemployment and growth. Considering Greece, the three-years ESM financial assistance was concluded on the 20th August 2018. Even though it is exalted as a success, the reality is quite different. Greece received rescue funds amounting up to 203.77 billion euro (something unprecedented in modern history), favourable interest rates and longer maturity loans. Mario Centeno, the Chairperson of the ESM Board of Governors, stated that «Greece's economy is growing again, there is a budget and trade surplus, and unemployment is falling steadily». Actually, GDP growth rate is stuck at 1%, government debt is stuck at 179%, unemployment at 18.6% (with the youth one at 36.6%) and the government budget equals to 0.8% of the GDP. What Greece needs is actually further debt relief. The ESM implemented in 2017 to short-term debt relief measures that will reduce Greece's debt-to-GDP by around 25 percentage points until 2060 and its gross financing needs by 6 percentage points. Nonetheless, long-term debt is the one that still worries. Surely, Greece requires an exceptional and unique solution.

more promptly and early in similar situation should be set up. Yet, it should be also supported by a risk-sharing mechanism and market discipline for reducing bank exposures to sovereign.

A fiscal backstop, acting as an insurance or last-resort support for the already existent Single Resolution Fund (SRF), for further ensuring trust and confidence in the stability of the financial sector is highly recommended. Therefore, the establishment of a European Monetary Fund (EMF) might provide an appropriate solution by: (1) improving EMU robustness; (2) creating a more complete resolution mechanism and (3) working as a stabilization mechanism. It could be created by simply expanding the European Stability Mechanism (ESM) tasks, acting as a financial backstop, as the recent proposal suggests[519]. In this way, a similar mechanism would financially stabilize the Euroarea while increasing a risk-sharing function among the Eurozone countries, in case of a potential sovereign or banking crisis.

The EMF should be entitled to shelter governments and banks by enhancing stability. For example, in case of sovereign crisis, it might provide financial assistance to the debtor country while supporting it in taking the necessary provisions for an economic and fiscal adjustment and reaching debt sustainability without the unanimity process, which slows down the whole process[520].

The creation of the EMF could work similarly to the IMF, where capital contributions could be based on the risk the country represents for the whole Euro-area[521]. In addition to, conditionality on financial assistance (after an assessment) could be limited in order to avoid a scheme of permanent transfers and dependence. For instance, a limit of five times the capital contribution the country deposits, with a duration of three years, could be adopted[522].

---

[519] Recently, the creation of a European Monetary Fund has become a «fashionable topic» among the European institutions. The European Commission has advanced a «Proposal for a Council Regulation on the establishment of the European Monetary Fund» (also supported by the ECB) on the assumption that ESM's task should be extended upon Art. 352 TFEU. European Commission, ''Proposal for a Council Regulation on the establishment of the European Monetary Fund'', COM(2017) 827 final [2017].

[520] Considering the proposal, «unanimity voting [is kept] for all major decisions with financial impact (e.g. capital calls)». Nonetheless, it also suggests the adoption of a «reinforced qualified majority in which 85% of the votes are required, proposed for specific decisions on stability support, disbursements and the deployment of the backstop» for avoiding delays in taking some urgent decisions. European Commission, ''Proposal for a Council Regulation on the establishment of the European Monetary Fund'', cit., p. 6.

[521] Capital contributions to EMF could be based on a potential country risk, for example by considering debt levels. This mechanism would not be so different from the current scenario in the ESM, where contributions are based on a country's capital share of the ECB (respective country's share in the total population and GDP of the Euro-area). As a result, smaller countries have smaller capital shares in the ESM following the key contribution.

[522] To ensure a better crisis-management, three distinct approaches could be adopted: (1) For pure liquidity crisis, no conditions should be imposed; (2) in case of insolvency risks, light conditions might be attached accompanied by a precautionary credit line provided that debt is sustainable and (3) for clear insolvency crisis, financing might be provided on conditionality through a fiscal, financial and macroeconomic adjustment programme and a debt restructuring. G. Claeys, ''The missing pieces of the Euro architecture'', cit., p. 50.

The hypothetical EMF should undoubtedly develop an appropriate approach to monitor economic developments and the adoption of adjustment programmes[523]. Beyond question, lending should be made conditional on debt restructuring whenever a sovereign country is considered insolvent. On the contrary, in case of solvency, it would be preferable to ensure lending without debt restructuring[524].

What is important to recognize by creating a EMF should be the possibility of declaring a*n orderly default* (a way of engineering a methodical debt restructuring as a matter of last resort), where its costs shall be contained[525]. Indeed, if debt is unsustainable and the applied adjustments insufficient to recover from an unstable situation, it should be in a country's interest to make restructuring simply possible and exchange bad debt with safe provision (such as GPD-linked bonds that allow also for a suspension of debt-service-payment or safe debt held by the EMF). Debt-cut should be such to bring down the debt-ratio while further funds to the *defaulting country* could be used for specific purposes approved by the EMF, such as paying down the debt owed to the EMF.

The EMF could act as a moderator or intermediary to reschedule negotiations and secure an agreement between creditor and debtor countries. On the contrary, in the case of banking crisis, the EMF should operate as a fiscal backstop suggesting that this new institution should take part in the precautionary recapitalization and establish a credible credit-line in which markets and member states can trust[526].

A credit-line, which in the EMS already exists, would be a meaningful instrument for implementing a credible fiscal backstop in case of a sovereign crisis while ensuring more financial stability. Indeed, it

[523] According to art. 13 of the proposed EMF Statute, conditionality is to be negotiated by the Commission with the ECB and in conjunction with a weak involvement of EMF. In addition to, the current proposal envisages a Memorandum of Understanding to be signed both by the European Commission and the EMF. Basically, the Commission would act as a legal co-owner of the EMF conditionality where it would be monitored by the Commission, *in liaison with* the ECB, without an explicit role for the EMF. European Commission, ''Annex to the Proposal for a Council Regulation on the establishment of the European Monetary Fund'', COM(2017) 827 final, [2017], p. 3.

[524] With regards to conditionality, D. Gros and and T. Mayer have a very different approach. In their opinion it should be established a two-stages approach. In the first phase, a member country can request capital and financial assistance provided that its fiscal adjustment programme is established and approved by the Eurogroup. In the second phase, limited financial assistance is provided upon the adjustment programme that shall be under the direct scrutiny of both the European Commission and the Eurogroup. Moreover, their concept of EMF differ in terms of enforcement. In their opinions, in case of breach of conditions, structural funds shall be automatically suspended while the public debt shall not be eligible. D. Gros, T. Mayer, ''A European Monetary Fund: Why and How?', cit., pp. 2-3; pp. 8-9.

[525] As D. Gros and T. Mayer argue, a sovereign default mechanism is necessary for one main consideration: «The strongest negotiating asset of a debtor is always that a default cannot be contemplated because it would bring down the entire financial system. This is why it is crucial to create mechanism to minimise the unavoidable disruption resulting from a default. Market discipline can only be established if default is possible because its cost can be contained». *Orderly default* should be recognised as possible as it would be in a country's interest to cut its debt when it cannot make the adjustment effort. *Ivi*, p. 3.

[526] EMF could be allowed to borrow money on the capital market. Likewise, a country might submit a request of financial support and a fiscal adjustment plan, if it is encountering difficulties. If approved, member state might receive a contribution.

would provide financing, for a limited period, to those states that lose market access for issuing sovereign bonds[527].

The current European Commission's proposal for the European Monetary Fund presents surely some weaknesses.

Firstly, it does not make any reference to the possibility of debt restructuring which could be actually established by amending the ESM Treaty or establishing an intergovernmental agreement and new obligations. Secondly, the European Commission is supposed to have a major role in the creation of the European Monetary Fund, intended to be a Community institution rather than an intergovernmental body, thus omitting the apolitical character of a monetary fund[528]. Thirdly, the legal basis under art. 352 TFEU (*secondary legislation*) might not be the right approach for reasons of efficacy and independence for the EMF, as it is also contested not only by the Managing Director of the ESM but also by national governments. Rather, it would be preferable to amend the ESM Treaty with the aim of integrating the EMF in the EU Treaty and framework through a *primary legislation* or establish the EMF upon an intergovernmental agreement[529].

The Commission has proposed art. 352 TFEU (*flexibility clause*) as legal basis for the EMF Regulation as this articles entitles the Council to adopt *appropriate measures* whenever Union's action «is necessary to attain one of the objectives set out in the Treaties and the Treaties have not provided the necessary powers».

---

[527] The current European Stability Mechanisms (ESM) already provides two precautionary credit lines: (1) Precautionary Conditioned Credit Line and (2) the Enhanced Conditions Credit Lines (ECCL). Bruegel, J. Andritzky, Enhacing the ESM lending toolkit through a precautionary credit line, http://bruegel.org/2018/06/enhancing-the-esm-lending-toolkit-through-a-precautionary-credit-line/, published on the 11th June 2018, consulted on the 15th November 2018.

[528] The European Commission aims at «communitising» the ESM by anchoring it to the European Union legal framework. As it argues: «A stronger Economic and Monetary Union requires stronger governance and a more efficient use of available resources. [..]. Greater synergies, streamlined procedures and integration of intergovernmental arrangements within the EU legal framework would strengthen governance and decision-making. It is also for efficiency reasons that all the changes proposed by the Commission as part of today's package can be implemented within the framework of the current EU Treaties. […]. Completing the Economic and Monetary Union also means greater political responsibility and transparency about who decides what and when at the different levels. […]. Its [EMS] transformation into a EMF should be accompanied with an effort to anchor its functioning in the robust accountability framework of the Union together with a fully-fledged judicial control». European Commission, Proposal for a Council Regulation on the establishment of the European Monetary Fund, COM(2017), 827 final [2017], p. 3.

[529] Concerning the apolitical aspect of a monetary fund, it would be undoubtedly in contrast with the statement and intention of the current President of the European Commission, Jean-Claude Juncker. In 2014, following his appointment, he clearly stated his interest to preside «a more political Commission». National officials warned that the Commission Proposal would basically deprive the ESM of its independence and subordinate it to the European institutions. Also the Managing Director of the European Stability Mechanism, Klaus Regling, claimed that for a better functioning the EMF should be established as «the EIB [European Investment Bank], a body that is clearly anchored in the EU Treaty, but with its own protocol, its own capital and accountability to its shareholders». Klaus Regling, ESM Managing Director, A European Monetary Fund: for what purpose?, Euro 50 Group conference, https://www.esm.europa.eu/speeches-and-presentations/european-monetary-fund-what-purpose-speech-klaus-regling, published on the 10th April 2018, consulted on the 11th December 2018.

The objective of the EMF would be, indeed, to ensure the financial stability of the Euro-area, which falls, for sure, within the Union objective to create a well-working economic and monetary union. However, the question for the applicability of art. 352 TFEU might raise concerns whether its establishment is necessary to attain these objectives since a financial assistance mechanism already exists to safeguard Eurozone stability. Lastly, with regard to the current legal basis on which the EMF proposal relies, another doubt concerns the extension of the Union's competence.

The European Court of Justice (ECJ) clarified in its Opinion 2/94 that art. 352 TFEU «cannot serve as a basis for widening the scope of [Union] powers beyond the general framework created by the provisions of the Treaty as a whole and, in particular, by those that define the tasks and the activities of the [Union]». Therefore, it would be legitimate to ask whether a future EMF, acting as a legitimate Union body, would go beyond the powers conferred by the Union within this context[530].

Similarly, art. 125(1) TFEU might appear as a critical legal obstacle since serious concerns have been raised whether EMF would breach the *no-bail-out clause* and whether it qualifies for the exceptions established under art. 122 TFEU (*exceptional occurrences beyond control*). However, member states have added art. 136 TFEU, which states that «[t]he Member States whose currency is the Euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the Euro-area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality». Since this provision refers only to the establishment of a fund for Euro-member states (and not for the whole European Union), a violation of art. 125(1) TFEU would probably not occur. Moreover, the Pringle Case has even clarified that financial assistance might be given on a *strict conditionality*. As a result, a Fund - established by the Euro-member -states - that fulfils the Pringle conditions would be in line with art. 125(1) TFEU, even though it is not clear whether the Commission proposal completely satisfies these requirements.

Nonetheless, under art. 12 of the ESMT, «if indispensable to safeguard the financial stability of the Euro-area as a whole and of its Member States», assistance might be provided. Similarly, under art.3(1) of the proposed Regulation, «the EMF shall contribute to safeguarding the financial stability of the Euro area, as well as the financial stability of the participating Member States». Therefore, a crisis that threatens the stability of one single member states and not the whole Euro area might be sufficient for granting action and support from the EMF stressing that a similar assistance would be indispensable for the Euro-area stability.

[530] Under the proposal, the EMF shall have its legal personality, according to art. 1. This implies that EMF would be a unique body of law, which shall have its own Board of Governors and of Directors (art. 4). According to art. 7, the Council would be responsible for approving some important decisions, such as the appointment of the Managing Director, upon qualified majority. However, considering the current proposal, two complications emerge with regards to the qualified majority: (1) the threshold of qualified majority are different in art.4 from those set down in art. 238(3) TFEU and (2) the Council's approval (an institution of the whole EU) makes it fundamental for the decision of the EMF (conceived as an institution for the Euro-area members).

An assistance mechanism might be set up to provide assistance, if it is needed to ensure stability of the Euro area as a whole, so that the Pringle Case and art. 136(3) TFEU would be respected. Moreover, the EMF might be eventually implemented within the current framework of *enhanced cooperation* (as art. 20 TEU and 236 TFEU state)[531].

The current proposed Regulation is also weak for another important point as the EMF is held accountable to the European Parliament. According to art. 35(5), the Board of Governors «shall make the annual report accessible to the national Parliaments […] and shall simultaneously send the report to the European Parliament, the Council and the Commission». However, there are two major problems: (1) these are only reports and Parliament has no influence in decision-making of the EMF and (2) the European Parliament might be an inadequate body for EMF accountability as the EMF's members would be exclusively the Euro-area members while European Parliament and the Council are extended to the European Union member states. Basically, the EMF would be made accountable to an institution with a different composition of members from those that provide contributions.

In a world dominated by uncertainty, discontent and dissatisfaction, a correction in the current proposal would be much more desirable. Surely, in addition to legal concerns, the EMF would represent a further centralization of the EU authority to provide guarantees to ill-sovereign debtors, within an appropriate and adequate framework, while encouraging and fostering negotiations between creditors and debtors.

In case of another financial crisis, providing financing under conditionality and ensuring debt restructuring should occur under the EMF to encourage dialogue between debtors and creditors. The creation of an EMF would increase predictability and implement opportune action at the right moment. Surely, adding new innovative and efficient crisis resolution provisions would be beneficial in the long-term, as it would establish a strengthened market discipline and risk-sharing mechanism[532].

In case of another large crisis, the EMF could strengthen solid public and private finances, reduce the need of relying on the ECB (acting as a fiscal agent) and ensure the no-bail-out clause in the Treaties. If taken correctly, all these measures should strengthen market discipline and risk-sharing while breaking the reoccurrence of sovereign-bank loop and reducing further risks. Surely, a similar body

[531] The *enhanced cooperation* claims that once the Council acknowledges that a measures fulfil the Treaties' objective, then it must decide whether the Union (acting as a whole) can achieve the goal within a reasonable amount of time. If not, the Council can authorize nine member states to continue *enhanced cooperation* in this field, thus allowing them to move ahead with the legislation and eventually, to adopt it for themselves. K. Alexander, ''Sovereign debt restructuring in the EU: Lessons from the Recent Crisis'' in P. Delimatsis, N. Herger (edited by), *Financial Regulation at the Crossroads: implication for supervision, institutional design and trade, international banking and finance series,* Alphen aan den RijnKluwer, Law International BV, (2011), pp. 160-161.

[532] G. Pavlidis, ''Designing a Sovereign Debt Restructuring Mechanism for a European Monetary Fund'', *Intereconomics* LIII, IV (2018), p. 224.

would also require a plan to adopt an institutional change in the system with the aim of improving economic conditions and making structure more transparent[533].

3.2.2. Making the best of the European Single Market: Creating an ambitious Capital Market Union (CMU)

Promoting financial stability of the Eurozone system must be a priority in the long-term for all the Eurozone countries. Market integration could be, indeed, one of these elements that could help fostering economic growth and increasing European competitiveness. Even if Banking Union was completed, accompanied by the establishment of both a European Deposit Insurance System (EDIS) and supported by a European Monetary Fund (EMF), the Euro-area would still suffer from uncertainties related to a limited integrated European financial system.

In 2015, the European Commission launched a program through its Green Paper for implementing funds for investments and growth by establishing a more integrated and connected capital markets, being recognized as a policy priority. Indeed, even though freedom of capital movements was already included in the Treaty of Rome (1957), still liberalization in this field has been quite contained and slow due to delays in the negotiations concerning initiatives over securitization, issuing and offering of securities accompanied by an inefficient implementation of the project[534].

Eurozone crisis revealed many structural shortcomings within the system. Barriers continue to exist and prevail in the European market preventing countries from benefitting completely from financial integration. Indeed, the creation of the monetary union has not automatically implied an increase in cross-border retail payments and transactions. Rather, capital markets, i.e. equity and bonds, in the Eurozone and in the Monetary Union are still fragmented and heterogeneous in size and functioning. as they still keep a national connotation due to several barriers in selling funds, such as different tax regimes and jurisdictions.

Even though European policy-makers and leaders describe the bank-based nature of the Eurozone financial system as a key strength and factor of stability, this excessive dependence on banks and a scarcity of alternative financing contribute actually to make the Euro-area more fragile and unstable. Developing reliable sources of non-bank based lending nature (in terms of bonds, equity,

[533] If a European Monetary Fund (EMF) is to be established, several considerations over the institutional framework will have to be made by recognizing three crucial points: (1) how to set up a mechanism for containing vulnerability to sovereign risks in debt issuance; (2) the definition of specific fiscal criteria to have access to the EMF and (3) ensuring debt restructuring without creating excessive imbalances among the other Euro-countries. G. Corsetti, L. Dedola, M. Jarocinski, B. Mackowiak, S. Schmidt, Business cycle stabilisation in the Eurozone: ways forward, https://voxeu.org/article/business-cycle-stabilisation-eurozone , published on the 23rd October 2017, consulted on the 21st November 2018.

[534] Art. 61(2) Treaty of Rome [1957]: «The liberalisation of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalisation of movement of capital».

crowdfunding and securisation) might improve the system as the Euro banking crisis revealed the drawbacks of this over-reliance[535].

Financial integration among Eurozone countries relied on short-term interbank markets, debt markets and bank-funding, which before the crisis were both fairly integrated and easily dismantled soon after. Surely, financial stability is thus further compromised and put into danger as these flows are extremely volatile and can quickly disappear. A rapid fragmentation of the financial system occurred putting into evidence both the weak and fragile integration and the excessive reliance on bank-lending, where banking sector assets amount up to three times European GDP. Furthermore, the overall scenario was and is still worsened by a predominant domestic reality being discouraged by the high transaction costs in contrast to other single markets, such as the USA[536]. As a result, besides the consequent fragmentation (due to the local and domestic reality), a low-risk sharing between the European countries appears, which is the main cause for the build-up of bubbles and fast decrease in capital flows in case of instability or crisis.

Completing the single market could stimulate both private investments on the European territory creating better opportunities and returns by a better financing, i.e. equity.

Capital market stands as a very important channel for risk-sharing and for smoothing both consumption and investment besides the fact that it stands as a great contribution to financial stability. As a result, a diversification of the portfolio through a Capital Market Union (CMU) project would be advantageous for several reasons: (1) limitation of portfolio volatility which would be advantageous for both savers and smooth consumption; (2) improvement of investments; (3) reduction of macroeconomic shocks on both consumption and investment; (4) diversification of the funding system where non-bank financing should play a major role as bank-lending is unstable, volatile and pro-cyclical[537]. Banking lending remains the main financing in the Eurozone markets in contrast to the capital market, which has a very limited and modest role stressing that Euro-financial-market is dominated by banks - more prone to crisis and to less growth by nature[538].

---

535 N. Véron, G. Wolff, ''Capital Markets Union: A vision for the long-term'', *Bruegel Policy Contribution*, V (2015), p. 2.

536 A big challenge for the Eurozone countries is represented by the high costs imposed on payment system and securities, which undoubtedly contribute to a dysfunctional, inefficient and fragmented single market and discourage investment. In Europe, cross-border securities are estimated to be ten times higher the costs in the United States, oscillating between 15 and 20 euro, which stands as a serious problem and challenge, especially, for the small businesses. Nonetheless, some provisions have been recently been adopted under Regulation (EC) No 924/2009 of the European Parliament and of the Council of 16th September 2009 on cross-border payments in the Community and repealing Regulation (EC) No 2560/2001, with the aim of unifying the single payment market for both consumers and businesses and reducing cross-border transactions. European Commission Press Release, Cross – Border Payments, http://europa.eu/rapid/press-release_MEMO-18-2424_en.htm, consulted on the 28th March 2018, consulted on the 16th November 2018.

537 G. Claeys, ''The missing pieces of the Euro architecture'', cit., pp. 7-8.

538 As the European Central Bank highlights, by looking at Eurozone market, bank-lending stands as the main and prevailing channel for financial intermediation, in contrast to the US that are dominated by equity and securities. In Eurozone, debt securities and corporate bonds play a limited role while equity financing, even

Integrating cross-border European capital market seems a necessary condition for improving efficiency and risk-sharing among Eurozone and European countries while working as a shock-absorber for asymmetric shocks by developing non-bank financing and limiting financial instability risk, as also the President of the Commission, Jean-Claude Juncker stressed[539]. Eurozone still lacks appropriate adjustment mechanisms, a fiscal-transfer-system and an autonomous and adequate monetary policy[540].

Surely, like any other political decision, it will not be easily achieved and should be rather considered a long-term project mainly because the structure of financial intermediation changes slowly. Nonetheless, the European Commission launched already in September 2015 an ''Action Plan'' for establishing an integrated capital market by 2019[541]. It would require a reform of the current financial European system, such as: (1) the promotion of equity financing, (which have lost importance in the Euro-area) being more stable and less pro-cyclical than debt financing; (2) the promotion of venture-

---

though it has increased in importance, is rarely used for financing small and medium enterprises. Furthermore, private households' portfolios are mainly bank-based. Besides the fact that bank lending remains the main financial instrument in the European economy, financial intermediation is kept at national level, thus preventing even risk-sharing, while capital market plays a very limited role. Even though it has increased after the adoption of the Euro, cross-border financial risk-sharing is quite low. Generally speaking, Eurozone financial integration has modestly improved and recovered since the European sovereign debt crisis. Indeed, developments across money, bond, equity and markets are modest but still uneven. Hence, it is of vital importance to complete banking union while improving capital market. European Central Bank, Financial integration in Europe, *Official ECB Report,* V (2017), pp. 10-14.

539 In his first speech to the European Parliament in 2014, the newly-elected Commission President, Jean-Claude Juncker, stressed the need of setting the Capital Market Union as one of the main priorities during his mandate. He thus claimed: «Over time, I believe we should complement the new European rules for banks with a Capital Markets Union. To improve the financing of our economy, we should further develop and integrate capital markets. This would cut the cost of raising capital, notably for SMEs, and help reduce our very high dependence on bank funding. This would also increase the attractiveness of Europe as a place to invest». J.C. Juncker, ''A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change'', Opening Statement in the European Parliament Session, European Commission, 15th July 2014.

540 Countries have three different channels for smoothing their consumption beyond a recession: (1) *fiscal channel*, which by means of fiscal transfers and taxes, contributes to reducing the impact of the asymmetric shocks; (2) *credit channel*, which smooths consumption through borrowing or saving whenever an economic shock emerges; (3*) capital market channel*, which by means of incomes, interests and dividends on cross-border investments mitigates the impacts of shocks on both domestic production and consumption. G. Claeys, ''How to build a resilient monetary union? Lessons from the Eurocrisis'', cit., p. 19.

541 In September 2015, the European Commission adopted an action plan, defining 30 actions and measures to achieve an integrated block of capital market in the EU by 2019. This clarified the top priorities for strengthening European economy and investment and creating new jobs. Capital market union would help mobilise capital and channel them into infrastructures and SMEs while better connecting financing projects across the EU. Similarly, in June 2017, the European Commission updated and completed the CMU Action Plan by strengthening the existent actions and introducing new measures (nine priorities actions) for coping with the current challenges. As it stressed: «CMU seeks to overcome the EU economy's reliance on bank-lending by providing a more diversified system in which non-bank finance efficiently complements the traditional banking channels». To know more about the Priorities Actions, I suggest to read: European Commission, ''Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the Mid-Term Review of the Capital Markets Union Action Plan'', COM(2017) 292, [2017].

capital equity (VCE) for financing firms and innovative sectors with a high potential growth[542]; (3) a revision of tax treatment concerning equity; (4) an harmonization of financial standards concerning savings, restructuring and taxation of financial products[543].

To provide further financial stability, the completion of the Capital Market Union (CMU) should occur simultaneously to the improvement of the Banking Union and the adoption of prudential policy for several considerations: (1) a better and smooth functioning of the Economic and Monetary Union; (2) an implementation of cross-border financial risk-sharing and investment flows that are crucial for the quality of the financial integration[544]; (3) a better resilience of both the financial and economy system; (4) an appropriate institutional framework for avoiding *regulatory arbitrage*, i.e. practices for bypassing unfavorable regulations[545].

In order to create a well-functioning Capital Market Union, the development of banks and externalities should be contained through the adoption of an intense Banking Supervision under the Single Supervisory Mechanism (SSM) and an adequate level of the systemic risk supervision and monitoring also for the non-bank elements under the already existent European Systemic Risk Board (ESRB)[546].

A Capital Markets Union, supported by a completed Banking Union, would be sufficient to enhance a better regulation and supervision of the financial markets and the European economy – absorbing losses from feasible crisis and systemic risks - provided that also a deposit insurance mechanism, working as a fiscal insurance, is set up.

Surely, completing a Capital Market Union is a very ambitious project since a true and efficient financial integration would also require significant changes concerning the domestic and national

---

[542] According to N. Véron and G. Wolff, the entities that would enjoy the most from the integration of the capital market union are the Small-Medium Enterprises (SMEs), especially the youth and high-growth, which play a crucial and central role in job creation in the Euro-area. Being so important, even their financing stands as a central challenge for the EU. Since the role of the SMEs in capital market is minimal as they mainly rely on bank-lending, developing a more dynamic market with equities and venture capital would be helpful for their funding and financing. N. Véron, G. Wolff, ''Capital Markets Union: A vision for the long-term'', cit., p. 7.

[543] G. Claeys, ''How to build a resilient monetary union? Lessons from the Eurocrisis', cit, p. 20.

[544] Risk-sharing can take different forms. Both intertemporal private risk-sharing such as commercial bank loans and the institution-based capital flows, supported by cross-sectional private risk-sharing, such as equity transactions, FDI and market-based capital flows, can ameliorate the financial integration. Especially, the former can provide a shelter and financial safeguard to idiosyncratic shocks and European system during economic shocks. D. Valiante, Europe's untapped capital market, https://voxeu.org/article/capital-market-union-europe, published on 13th March 2016, consulted on the 28th November 2018.

[545] A. Sapir, N. Veron, G. Wolff, 'Making a reality of Europe's Capital Markets Union'', *Bruegel Policy Contribution*, VII, V (2018), pp. 2-3.

[546] Following Regulation EU 1092/2010 of the European Parliament and Council, the European Systemic Risk Board (ERSB) was established with the primary aim of monitoring and assessing systemic risk in the EU financial system and issuing warning and recommendations when necessary (upon art. 3 of the Regulation, which defines *mission, objectives and tasks*). It is thus tasked with macro-prudential oversight of the Euro-area to contribute to the prevention and mitigation of systemic risk. Moreover, it shall contribute to the smooth functioning of the internal market and ensure a sustainable contribution and support of the financial sector for the economic growth.

legislation. As a matter of fact, it should be considered a long-term structural transformation which needs the right legal framework. It would request enormous efforts and an efficient level of harmonization in terms of accounting, auditing practices, investment taxes, bankruptcy and restructuring laws while it would also need the removal of barriers concerning insolvency regulation. Hence, such a project cannot emerge by 2019 since a successful CMU will emerge only when legal and regulatory impediments and economic barriers will be removed for achieving the needed risk-sharing and once that banks' reluctance will be overcome. More focus should be thus put on deepening financial market integration and promoting infrastructure investments. Besides being inefficient, indeed, a fragmented financial sector might be damaging due to its inability to attract foreign investments[547].

Capital market union (CMU) would basically combine the benefits of deepening and integrating financial markets while ensuring risk mitigation and reduction of the sovereign-vicious loop. Deeper and more integrated capital markets would basically increase private-risk sharing providing sufficient and adequate shocks against asymmetries within Eurozone while eliminating considerations over the need of proceeding towards Eurozone Fiscal Union. In addition to, it would enhance and foster a better transmission of the monetary policy[548]. Nonetheless, the creation of the Capital Market Union and the increase in risk-sharing should be accompanied by an effective and efficient institutional architecture for removing barriers. Requirements for a fair and non-discriminatory market entry, accompanied by the guarantee for a smooth performance of the financial contracts, should be helpful for preventing financial instability.

3.2.3. Reforming the European Central Bank: The right time for a dual-mandate, accountable and transparent bank?

The European Central Bank has emerged as an evolving institution in time of crisis by expanding its toolkit. ECB's response to financial crisis has been significant and has seen the adoption of new instruments and tools. In particular, the global financial crisis moved considerations whether ECB monetary policy should be concerned also with financial stability.

By the time of the Big Crisis, ECB started operating as a Lender of Last Resort (LOLR) with an initial reluctance and then, activated the Quantitative Easing (QE) even though with some hesitations[549].

---

[547] M. Xafa, Where we stand on European Capital Markets Union, https://voxeu.org/article/where-we-stand-european-capital-markets-union, published on the 17th April 2018, consulted on the 28th November 2018.

[548] G. Thirion, ''European Fiscal Union: Economic rationale and design challenges'', *CEPS working document*, I (2017), p. 12-13.

[549] The ECB has always claimed that its position during the financial crisis has been expansionary enough. This explains why ECB initially was reluctant in activating the QE programme, even though Eurozone economy and recovery were slowing down. ECB is much less concerned with unemployment rates than other central banks, such as the FED. This main difference lies in the different mandate. The FED's one is equally focused on ensuring maximum employment, growth and price stability. On the contrary, ECB is much more concerned with price stability while financial stability, in terms of support to economic policies, is only a

Inevitably, its action plan has been criticized on two different assumptions. On the one hand, the ECB might have acted in an excessive way beyond its mandate and on the other, it should have done much more for sheltering both Eurozone and enhancing economic growth and recovery[550]. Besides acknowledging price stability as the primary objective, the EU Treaties state clearly that the European System of Central Banks (ESCB) should pursue a smooth functioning of policies for the financial stability[551].

The financial crisis put undoubtedly financial stability at the very centre of the European Central Bank's functioning. Indeed, it triggered a very complicated and lengthy transformation process for its competences and tasks in crisis-management.

Within the boundaries of the Treaty, the monetary policy has surely undergone significant changes over time. Likewise, the ECB has gone through a very innovative journey shifting from a traditional central bank to a more modern one by adopting unconventional tools, non-standard measures (intervening in the bond markets) and asset purchases[552].

Moreover, as a result of the financial crisis, ECB adopted policies that nowadays hinder an efficient monetary policy transmission due to the Zero-Lower-Bound (ZLB) constraint and large balance sheets[553].

---

secondary priority, provided that it does not endanger the first target. Surely, the interpretation is debatable but the financial crisis has put into evidence the main concerns for the ECB: its balance sheet, credit and inflation, in contrast to FED that has become more focused on economic situation. Indeed, the ECB has expanded its liquidity capacity only to contain crisis and shelter Euro from a mere fall and seems quite uncomfortable in keeping the role of LOLR. C. Wyplosz, What you ought to know about the ECB and Unemployment, https://www.socialeurope.eu/ecb, published on the 18th February 2014, consulted on the 30th November 2018.

[550] The European Court of Justice was asked by the German Constitutional Court to provide a preliminary ruling on whether the ECB had actually breached the EU law by activating the OMT (the bond purchasing programme). According to the Bundesverfassungsgericht (Federal Constitutional Court), this decision exceeded the mandate of the ECB or infringed Article 123 TFEU. On the contrary, according to the European Court of Justice, «it follows from the foregoing that, in adopting Decision 2015/774, the ECB did not exceed its mandate, as defined in Article 119 and in Article 127(1) and (2) TFEU and that the PSPP [Public Sector Purchase Programme] was established and implemented in accordance with the principles of conferral and of proportionality set out in Article 5(2) and (4) TEU». Court of Justice of the European Union, Case C-493/17, Weiss and others, [2018].

[551] Art. 127(5) TFEU: «The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system».

[552] G. Claeys, M. Demertzis and J. Maza. ''A monetary policy framework for the European Central Bank'', *Bruegel Policy Contribution*, XXI, XI (2018), p. 1-2.

[553] As already mentioned in the second chapter, before the crisis, the ECB relied on short-term policy interest rates through the main refinancing operation rate (MROR) to control the functioning of EONIA. Nonetheless, once the ZLB was reached, the ECB developed several tools – forward guidance, long term refinancing operations (LTRO), targeted longer-term refinancing operations (TLTRO) and changes in the balance sheets' size and maturities - to control the markets rates. Finally, since 2015, the ECB also opted for a diversified asset purchases programme, which initially included asset-backed securities and covered bonds, and was then extended to sovereign and corporate bonds.

Being weakened by an inadequate and highly fragmented fiscal structure of the Economic Monetary Union (EMU) to face economic shocks, Eurozone countries tend to rely excessively on monetary policy as a countercyclical economic stabilization tool[554].

ECB is a modern, effective and prepared central bank to serve the goals of monetary union, such as delivering the priority of price stability and contributing to favourable growth conditions and financial stability. Over the last twenty years, the ECB has pursued more or less successfully its target – price stability with an inflation less but close to 2% - under the definition adopted by the ECB Governing Council in 1998 and then, in 2003[555].

Yet, the inflation target in the Eurozone has been a success only on average - around 1.9% - even though the last periods, especially after the financial crisis (2012-2017), have been characterized by deflation[556]. Therefore, due to difficulties experienced lately in reaching the target, a revision of the current target might be desirable.

Since no numerical constraint or reference is present in the Treaty, a more flexible value could be changed and adopted, if necessary, by including more wide instruments, such as the inclusion of tolerance bands, a major flexibility for pursuing a sustainable growth rate, the revision of the two-pillar strategy - credit and monetary aggregate - and finally, a definition of a monetary policy over a wider time-period[557]. Surely, a more up-to-date strategy would be desirable, especially if it is more

---

[554] ECB is further weakened by framework in which it moves. Indeed, the current European fiscal policies are not countercyclical but rather, inefficient and imperfect. As a result, besides not providing the required and needed stabilisation, the current framework is suboptimal being fiscal coordination inadequate to satisfy Eurozone countries' needs. Consequently, national countries tend to rely excessively on ECB monetary policy which is, in any case, hindered by the ZLB. Lastly, being constraint by monetary refinancing prohibition, high default risks might persist, even though both the Outright Monetary Transaction (OMT) and the European Stability Mechanism (ESM) have been placed. G. Claeys, M. Demertzis and J. Maza. ''A monetary policy framework for the European Central Bank'', cit., p. 8

[555] Already in 1998, the Governing Council announced the adoption of a "stability-oriented monetary policy strategy" to attain the goals set out in the Treaty. The strategy was a sort of hybrid based on two main strategies. As described in the ECB Monthly Bulletin of January 1999: «The strategy consists of three main elements: (i) a quantitative definition of the primary objective of the single monetary policy, namely price stability; and the "two pillars" of the strategy used to achieve this objective; (ii) a prominent role for money, as signalled by the announcement of a reference value for the growth of a broad monetary aggregate; and (iii) a broadly based assessment of the outlook for future price developments and the risks to price stability in the euro area as a whole». In May 2003, the ECB published a review of the monetary policy framework by defining a value close but below 2% and the introduction of an economic analysis to identify both short and medium-term risks to price stability.

[556] Financial Times, ''Five reforms the ECB should embrace'', https://ftalphaville.ft.com/2018/10/15/1539576001000/Five-reforms-the-ECB-should-embrace/, published on the 15th October 2018, published on the 29th November 2018.

[557] It would be desirable for the ECB to reconsider the two-pillar strategy – credit and money aggregate – on which it relies to evaluate and estimate risks to price stability. Being based on an analysis of economic and monetary data, they have sometimes mislead a right and appropriate approach for monetary policy stressing that they might not be the right predictors for inflationary pressure. For example, ECB raised interest rates by 0.5% in 2008 to cut inflation, despite political opposition and European economic downturn. Being the two-pillar strategy defined by the ECB, it could be changed without amending the Treaties and Statute. Financial Times, ''Five reforms the ECB should embrace'',

favourable to growth and employment, without affecting the price stability target. Indeed, in the Treaty, there is no provision prohibiting ECB from considering also unemployment and other factors for setting interest rates.

Beyond question, all major central banks in the most advanced economies have introduced numerical targets for fighting inflation and have adopted the necessary tools for reaching it. However, the current definition of price stability is not only asymmetric (since 2% inflation is compatible only with 2% increase in unit labour costs) but also embedded with an ambiguous interpretation being based on «below but close to 2%»[558].

Structural changes in the European Central Bank are undoubtedly required by increasing temporarily the inflation target that should be supported by suitable macro-prudential policies for avoiding another crisis within the Monetary Union. Therefore, the ECB should adapt its monetary policy in a more flexible way in the future for providing an increasing transparency and flexibility to cope with this uncertain scenario.

Reconsidering the definition of the target while pursuing a more flexible inflation, would be appropriate. Rather than insisting on pursuing «below but close to 2%» inflation target, the ECB might adopt a definition that assesses inflation «around 2% on average» distributed over a long-term and not the medium - a two-years-horizon. Moreover, it could introduce careful tolerance bands for defining acceptable and non-acceptable levels of inflation, especially during the process of unit labour cost adjustments (them being one of the main factors influencing the inflation target). This would allow to deviate from the target, at least in the medium-term.

An approach based on the long-term would be beneficial and advantageous for several reasons: (1) avoiding further mistakes on behalf of the ECB, such as raising interest rates in inappropriate moments, in 2008 and 2011; (2) increasing flexibility in the conduct of monetary policy which would allow European economy to recover and eventually, to «*explode*» after a long period of slow economic growth. (Monetary policy affects directly financial stability and vice-versa as the recent scenario demonstrated, since the current ZLB is both affecting ECB's manoeuvre and economic growth); (3) a target on an average inflation would strengthen the role of inflation expectations as an automatic stabilizer and (4) long-term investments could be better planned[559].

---

https://ftalphaville.ft.com/2018/10/15/1539576001000/Five-reforms-the-ECB-should-embrace/, published on the 15th October 2018, published on the 29th November 2018.

[558] The definition of the Central Bank risks leading Eurozone's economy in a deflationary territory. Basically, by defining «close», the ECB could target on purpose a smaller number than 2% while «below» raises a problem of unclarity and uncertainty. By imposing this target without flexibility, the ECB denies the possibility of a coordinated, clear and comprehensive numerical goals**.** B. Eichengreen, C. Wyplosz, ''Minimal Conditions for the survival of the euro'', cit., p. 36.

[559] G. Claeys, M. Demertzis and J. Maza. ''A monetary policy framework for the European Central Bank'', cit., pp. 9-13.

Since ECB has gradually enlarged its competences and tasks, it is worth to ask whether also a change in monetary policy strategy should occur especially in a moment in which ECB is powerless having interest rates hit the Zero-Lower-Bound (ZLB).

By rethinking the price stability definition, inflation-target could be slightly increased which could beneficial in reaching price stability in the long-run. Reoccurrence of deflation and disinflation could be removed while interest rates would be less prone to hit the ZLB in the future. Hence, uncertainty and instability could be better managed in the medium-term and distorting outcomes avoided, even though costs on the economy could be great[560].

A change in the inflation target should be accompanied by suitable macro-prudential and fiscal policies provided that they are consistent with price stability. In this way, credibility would be built up and expectations better anchored[561].

Since Eurozone economy is experiencing a «secular stagnation», a phase characterized by low interest rates and sluggish output growth, the big challenge would consist in reaching a slightly higher inflation target[562].

Better predictions of inflation can be obtained by including broader concept of unemployment and slack in the economy. Being economic activity multifaceted and multidimensional, it would be appropriate to use wider dynamic models to estimate and evaluate inflation. There is not, indeed, a unique level of unemployment that corresponds to a stable structural level, above which expansionary macro-policy automatically accelerates inflation[563].

---

[560] As also the economist Paul Krugman says, targeting higher inflation rates (even though it might be controversial) could help overcome deflationary pressure and restore competitiveness. A higher inflation target would basically reduce drop in output, deterioration in fiscal policies and unemployment (with higher inflation rates, it is indeed difficult to cut also nominal wages). As he suggests, a 4%-inflation target would remove obstacles imposed by monetary policy on interest rates by the ZLB, stressing that economic shock and crisis would be much less frequent. Indeed, nominal interest rates would be allowed to fall much more - by a maximum 6% - than with the current 2%-inflation target. By having a higher inflation rate, also nominal interest rates are higher. Hence, in case of recession, rates can fall more before hitting the ZLB. L. Ball, The case for 4% inflation, https://voxeu.org/article/case-4-inflation, published on the 24th May 2013, consulted on the 1st December 2018.

[561] Also Vitor Constancio, Vice-President of the ECB, stated that «a substantial overhaul of current strategies would in the end be necessary. Options that have been proposed in this context include the abolition of cash, to eliminate the arbitrage opportunity which prevents policy rates from going negative, and a higher inflation target to reduce the likelihood of hitting the lower bound even after large, adverse shocks. In my view, on the issue of the abolishment of cash, "a prudent policy-maker would advise to be very cautious before proceeding with this radical proposal, even if digitalisation may gain ground and finally prevail – as we start to observe in some countries». Vítor Constâncio, ''Past and future of the ECB monetary policy'', https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180504.en.html, uploaded on the 4th May 2018, consulted on the 7th January 2018.

[562] M. Demertzis, Raising the inflation target: a question of robustness, Bruegel Blog Post, http://bruegel.org/2017/06/raising-the-inflation-target-a-question-of-robustness/, published on the 22nd June 2017, consulted on the 1st December 2018.

[563] ECB adopts a dynamic factor models that considers both a trend/cycle decomposition of real activity variables and also core inflation (the long run trend in price levels).

Surely, increasing inflation targets might be problematic as credibility of the ECB might be put into question. Nonetheless, correction in the current inflation target might be needed, even though critics could be advanced[564].

Improving the definition of price stability is an attractive step for creating a more flexible framework. Yet, the European Central Bank should also become more willing to adopt a different approach, focused on a dual mandate: both price stability and financial stability to stimulate growth and employment. Indeed, without a substantial change, the EMU cannot be fully exploited[565].

To reduce the likelihood of further economic crisis, financial stability should be an equally important objective that the ECB should set as strict inflation target can be rather detrimental and dangerous, even though it would require an amendment of the ECB mandate or at least, a clarification of art. 127 TFEU (to be read with art. 3 TEU)[566, 567].

---

[564] Different are the considerations on how to change and adapt the monetary policy strategy to the current economic scenario (low inflation, low economic growth, low interest rates). Two of these come from the former chairman of the Federal Reserve, Ben Bernanke: (1) targeting a higher value of inflation to 3% or 4%, where if credibility stands, it would lead to higher interest rates, even though problems come in the forms of long-term economic planning or price signals' interpretation in markets and lastly political backlash or (2) a temporary switch to price-level targeting where «a price-level targeter commits to reversing temporary deviations of inflation from target, by following a temporary surge in inflation with a period of inflation below target; and an episode of low inflation with a period of inflation above target». Besides being more flexible, this second option is consistent with low average inflation (2%) over time and with price stability too. B. Bernake, Temporary price-level targeting: An alternative framework for monetary policy, https://www.brookings.edu/blog/ben-bernanke/2017/10/12/temporary-price-level-targeting-an-alternative-framework-for-monetary-policy/, published on the 12th October 2017, consulted on the 6th January 2019.

[565] Art. 127 TFEU clearly expresses price stability as main priority, implying that little room is left for other policies. Indeed, the ECB focuses exclusively on monetary policy for controlling inflation - it being acknowledged «a monetary phenomenon». According to the ECB: «In the long run a central bank can only contribute to raising the growth potential of the economy by maintaining an environment of stable prices. It cannot enhance economic growth by expanding the money supply or keeping short-term interest rates at a level inconsistent with price stability. It can only influence the general level of prices». Still, according to the ECB, keeping price stability is the most effective and successful way to guarantee financial stability, which remains however the main responsibility of the national authorities. European Central Bank, Scope of monetary policy, https://www.ecb.europa.eu/mopo/intro/role/html/index.en.html, consulted on the 9th December 2018.

[566] Defining financial stability is a much more complex concept than price stability. Indeed, it touches different dimensions that cannot be encompassed by one single index, as in the case of price stability through the Harmonised Index of Consumer Prices (HICP). Financial instability occurs when financial assets tend to diverge significantly and where both market functioning and credit availability are compromised. As a result, both rapid credit growth and large rise in assets prices might increase the occurrence of financial instability. Asset prices and credit growth, in other words, can provide important information about the financial situation and the overall developments that can threaten financial stability. P. De Grauwe, D. Gros, ''A new two-pillar strategy for the ECB'', *CESifo working paper*, MMXVIII (2009), pp. 6-10.

[567] Art. 127 (1) TFEU: «Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union». Art. 127(5) TFEU: «The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system». Art. 3(3) TEU: «The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth

The European Treaties and the Statute leave indeed an enigmatic grey area with regards to the role of the European Central Bank (ECB) in ensuring the safeguard of the debt market from panics and speculative attacks, even though OMT program with the ESM – both deemed credible by investors - proved sufficiently efficient in deterring the financial contagion.

The governance of the ECB has been enormously influenced by the fact that it should be only concerned with price stability. Nonetheless, also financial stability should be one of its concerns as the Central Bank is the main institution entitled and capable of stabilizing the financial system in distressful situations.

What role should the ECB have in this field is surely a question of debate, especially from a legal point of view. Both the «*principle of conferral*» and «*institutional balance*» should be considered when referring to the role of the ECB in financial stability[568].

Surely, the Treaties do not clarify financial stability as the primary objective of the ECB and did not provide neither a financial-stability oriented instruments nor institutional framework. Nonetheless, the treaties clarify a limited and contributory role of the ECB in this field – conceived as «the stability of the financial system» - to prevent shocks from disrupting consequences in the economy[569]. Art. 127 TFEU clarifies ECB's financial role, in addition to price stability in three main areas: (1) *contribution*, under art. 127(5) TFEU; (2) *consultatory* and *advisory role* under art. 127(4) TFEU and (3) *promotion of smooth operation of payment system* under art. 127(2) TFEU.

---

and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance». Within this framework, the OMT facility (unlimited but conditional liquidity in the government bond markets) is perfectly justified leaving also open the possibility to extend ECB's sphere of action.

[568] Being the European Union based on the rule of law, every single European institution is required to act within the «*principle of conferral*» (Art. 4 and 5 TEU) according to which EU bodies can act only within the competences conferred by member states and set out in the Treaties. Similarly, they are obliged to respect both *«the principles of subsidiarity and proportionality»* and *«the principle of institutional balance»*, according to which the EU institutions and bodies shall act in accordance with the powers conferred on it by the Treaties and with the division of powers. This principle is derived from the Meroni Judgment of the European Court of Justice in 1958 in Case 9/56: «There can be seen in the balance of powers which is characteristic of the institutional structure of the Community a fundamental guarantee granted by the Treaty in particular to the undertakings and associations of undertakings to which it applies. To delegate a discretionary power, by entrusting it to bodies other than those which the Treaty has established to effect and supervise the exercise of such power each within the limits of its own authority, would render that guarantee ineffective». European Court of Justice, *Meroni vs. High Authority*, Case 9/56, [1958], p.52.

[569] As Yves Mersch, Member of the Executive Board of the ECB, held in his speech: «Financial stability remains a protean concept, with various manifestations and different understandings of its basic aspects. [..].The ECB approaches financial stability in terms of systemic risk: financial stability is a state whereby the build-up of systemic risk is prevented. In turn, systemic risk is "the risk that the provision of *necessary financial products and services* by the financial system will be impaired to a point where economic growth and welfare may be materially affected». Y. Mersch, Member of the Executive Board of the ECB, Financial stability and the ECB, ESCB Legal Conference, Frankfurt, 6 September 2018, https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180906.en.html, consulted on the 23rd December 2018.

The ECB has thus tasks to support the general economic policies in the Union with the idea of contributing to the Union's objectives suggesting that it could provide a new definition of financial stability without the need of revising the ECB's mandate[570]. *Contribution* does not establish a very specific and independent competence for the ECB, unlike for price stability.

Since instruments on how to ensure financial stability are neither specified in the Statute nor in the Treaty, the ECB can provide a more appropriate definition and similarly, it could contribute to financial stability through its already present tools by improving the two-pillar strategy (monetary and economic analysis) defining monetary policy. The ECB might indeed use its policy tools to address financial stability which would fulfil anyway the main objective: price stability[571].

Surely, financial stability – intended as a well and smooth functioning of the financial market – is necessary for ensuring monetary policy transmission, even though price stability shall always enjoy primacy. Moreover, policies for preserving financial stability should respect the principle of proportionality[572].

Art. 127(6) TFEU allows the Council to confer - with a simplified procedure - specific role and tasks to ECB on prudential supervision, as it happened with the SSM, contributing in this way to financial stability. The SSM regulation establish both microprudential and macroprudential tools contained in the SSM Regulation.

At the time of the Maastricht Treaty, financial stability between financial and business cycles were not a primary consideration but since times have changed, maybe also the ECB's approach should do the same by having a wider role.

Even though art. 127 TFEU suggests only a *contributory* and *supporting role* for financial stability, a wider and more appropriate definition over instruments might be desirable. Ensuring financial stability would be in line with micro-prudential supervisory competences.

---

[570] Art. 127(5) TFEU makes explicit reference to financial stability stressing that the ESCB should contribute to a smooth conduct of policies pursued by competent authorities suggesting that the ESCB are anyway given a contributory role in financial stability that might be exercised either through supervisory task or by supporting other competent authorities.

[571] Financial stability is a sort of pre-condition for monetary policy to achieve price stability objective. Indeed, monetary policy transmission cannot arrive to the real economy without a stable and well-functioning banking system. A stable banking system is undoubtedly a precondition for any central bank to achieve the mandate of safeguarding a currency stability. As a result, both monetary policy and macro-prudential policy stand as strategic complements. A more active macroprudential policy allows also an accommodative monetary policy while supporting a macroeconomic recovery in line with price stability – it being the primary objective of the ECB. In addition to, the central bank has a very profound knowledge with regards to the function of financial markets as they always monitor conditions to identify both vulnerabilities and threats to financial stability. Similarly, macro-prudential policy address feasible risks in financial stability.

[572] In Gauweiler Case, the Court of Justice claimed that measures intended to preserve the monetary transmission may be considered as pertinent to the objective of maintaining price stability.

Without any doubt, financial stability shall not be guaranteed only by the ECB but also by different institutions and actors who share responsibilities (banks and European governments)[573].

When analysing financial stability, the European Central Bank should look at variables beyond the Euro-Area when it intends to evaluate potential dangers to Eurozone financial stability. It is, indeed, possible to monitor risk of financial crisis by considering few indicators such as stock prices, housing prices and bank credit[574].

The pursuit of financial stability involves also choices and distributional implications which would request further accountability of the ECB and surely, might threaten also its independence.

During the financial crisis, the central bank increased massively liquidity to save the banking system and with some hesitations, it activated also the OMT and the SMP Programme for calming down the sovereign bond markets. The ECB should continue acting as lender of last resort (LOLR) for both banks and governments when they experience a liquidity and solvent problem as it provides an implicit guarantee and significant confidence in time of crisis. Hence, deposit withdrawal and bank runs can be avoided while in case of government, the LOLR reassure bondholders and prevent nations bonds' selling that can start a very vicious circle. Higher interest rates might cause damages to government solvency resulting in fear of self-fulling default.

Appointing ECB as LOLR not only in the banking sector but also in the government, which would be in line with art.18 and art. 21 of the Statute, would be needed to avoid a self-fulfilling crisis and prevent a country from entering into a bad equilibrium with default-risks (high interest rates, recessionary forces, budgetary problems)[575].

---

[573] The Central bank fits into the interplay between monetary policy, banking supervision and macro-prudential policy. Surely, financial system is influenced by a mixture of interactions but still, banks remain at the very heart of financial intermediation. The ECB tends to relates financial stability to the stability of the core functions provided by the financial system while economic growth remains an ultimate point. Safeguarding financial stability is held by three main areas: (1) *microprudential supervision*; with the aim of ensuring the stability of individual financial institutions; (2) *macroprudential policy*, with the scope of ensuring stability of both the banking and financial system and (3) *monetary policy*, with the aim of providing liquidity under the lender of last resort to financial system. Microprudential supervision alone is not able to ensure stability of the banking system as it cannot monitor appropriately the systemic aspect of financial stability and similarly, monetary policy cannot contain sufficiently the impact of a financial crisis once it appeared. In accordance with the Treaties and the SSM Regulation, the ECB has legal responsibilities in monetary, micro- and macro-prudential areas as the ECB is now supervisor with shared responsibilities in national competent authorities to address financial imbalances and systemic risks.

[574] P. De Grauwe, D. Gros, ''A new two-pillar strategy for the ECB'', cit, p. 8.

[575] Art. 18 of the Statute: « […] The ECB and the national central banks may operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in Community or in non-Community currencies, as well as precious metals.[..]». Art. 21 of the Statute: «In accordance with Article 101 of this Treaty, overdrafts or any other type of credit facility with the ECB or with the national central banks in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments [..]». Therefore, by carefully reading art. 18, the ECB does not incur into a violation of its protocol as government bonds are «marketable

Expectations of insufficient liquidity can be solved through «*a lending-coordination*» under the LOLR as the ECB did, since September 2012. Yet, opposition and reluctance are still high due to fear of inflation and moral hazard having a LOLR operating as an insurance[576].

The function of LOLR should be used in very limited case and only when banks or governments face liquidity problems and not insolvent. The ECB should understand that it is the only institution capable of stabilizing the financial system, in time of crisis, as it creates confidence. Moreover, the ECB can provide an unlimited amount of liquidity in contrast to the ESM, having limited resources and not providing the same credibility to halt contagion as its governance structure is ill-suited for crisis due to its veto power[577].

Surely, using interest rates for ensuring both financial and price stability would be inefficient and could cause great difficulties[578]. Therefore, in order to preserve financial stability, the ECB could actually adopt an additional and already existent instrument besides macro-prudential control (through Banking Supervision): the legal reserve requirements (a sort of tax on banks deposits to force bank to hold funds)[579].

Basically, the ECB could raise the minimum level of reserve requirements to be held by banks, in case of financial distress, for example excessive credit growth, to preserve financial stability while discouraging credit expansion in the banking system through a rise in bank credit, which would have proved effective in time of Eurozone crisis. Surely, for ensuring further financial stability, also

---

instruments». Thus, ECB is allowed to sell and buy in the secondary market while providing liquidity but to bondholders, usually financial institutions. As a result, a similar mechanism cannot be interpreted as a monetary financing of government deficits. Moreover, no provision is present in the Statute to hinder ECB in buying and selling bonds in the financial markets.

576 There were fears that by acting as LOLR, the ECB would have contributed to higher inflation as it bought government bonds and increased money stocks. In reality, as also P. De Grauwe highlights, liquidity support (in time of financial crisis) does not generate inflationary pressure since the banking sector is under pressure. Moreover, inflation can be defeated by increasing the minimum reserve requirements (that could be used by banks to expand credit). Likewise, moral hazard risk can be imposed by constraining rules in issuing debt for governments as it occurred through the European Semester (member states have to present their budget to the European Commission) and the Fiscal Compact or TSCG (the duty of maintaining equilibrium in the structural budget). Similarly, banks are now monitored at EU level through the SSM in attempt to prevent excessive risk and instabilities. P. De Grauwe, ‘’The European Central Bank as Lender of Last Resort in the Government Bond Markets, *CESIFO Economic Studies*, LIX, III (2013), pp. 522-528.

577 All major decisions in the ESM are taken upon unanimity. Nonetheless, the Treaty of the ESM (TESM) also acknowledges an emergency voting procedure – upon art. 2(4). In such case, financial assistance can be given if supported by a qualified majority of 85% of votes.

578 Monetary policy interest rates are not the best tool for responding to financial imbalances as they should not be used to prevent the build-up of financial imbalances. Due to the imperfect synchronisation between financial and business cycle, *leaning against the wind* might pose a trade-off between price stability and financial stability. This kind of policy actually requires an intentional deviation from price-stability over the short- and medium-term. Indeed, it might increase business cycle fluctuations while putting into danger the credibility of the central bank concerning inflation. On the contrary, a strong macro-prudential policy is required for ensuring both price stability and financial stability.

579 According to Art. 19 of ECB Statute, the ECB has the legal authority to impose the minimum reserve holdings (amounting to 2%) within Eurozone and the maximum permissible ratios. This variable has never been used for taking decisions over monetary policy and has never changed since its establishment.

macroprudential instruments (under the loan-to-value ratio and leverage ratios) are vital for ensuring and preserving a smooth stability while mitigating the impact of shocks.

Due to the great developments and changes, the ECB cannot be responsible only for price stability but also financial stability should be sooner or later acknowledged as an equal important objective. By adopting a different two-pillar strategy, the ECB would not be hindered in its functioning as the instruments would be separated. Indeed, it could continue to control interest rates for achieving price stability while adopting reserve requirements to maintain financial stability without incurring in a trade-off between the two instruments. There is no clause that prevents ECB from using this instrument in the attempt of preserving financial stability)[580].

A separation of the instruments is highly required so that both elements (inflations and financial stability) might be achieved. A similar two pillar-strategy might allow to keep the growth rate of M3 (monetary aggregate) and bank credit under control preventing interest rates from achieving very high levels . Being so focus on price stability, the ECB has sometimes underestimated financial instabilities. Without doubts, the ECB might be extremely defensive in changing the current framework, even though over the years, it has demonstrated to be a credible, innovative and evolving institution. Even though, by nature, central banks tend to be more conservative and less prone to innovations, the ECB should adapt itself to new challenges since its key characteristic of current monetary policies were established in the 1990s[581].

Finding new ways for conducting monetary policy is needed to manage the environment in which the ECB moves. Providing a new definition of price stability would not affect the Treaties, that require unanimity of the European member states to bring some amendments. The ECB's credibility, gained over the years, would not be affected and compromised provided that also communication and transparency continue to remain two very important tools for enhancing trust and credibility in the

[580] As P. De Grauwe and D. Gros demonstrate, had the ECB adopted a more adequate two-pillar strategy from the very beginning of its mandate, then both the growth rate of monetary aggregate (M3) and credit aggregate would have been kept under control (between 2003-2007) without increasing interest rates. Through the separation, the ECB could have increased the minimum reserve requirements and imposed more attention though macro-prudential control by lowering leverage ratios (the quantity of capital in the form of debt) and loan-to-value ratio (a key risk factor for lenders in qualifying borrowers of a mortgage). Even though credit expansion would have not been contained, the ECB could have avoided an increase in interest rates. The main mistake in the ECB relied in its monetary policy strategy (focused on the M3 as reference value) for guiding the economy towards price stability. Even though ECB was very close to its inflation target, this M3 growth rate prove inefficient (since the reference value of 4.5% was exceeded) as both credit and money aggregate were increasing since 2003. This was a clear sign of instability whose damages could have been contained had the ECB focused more on financial stability and less on price. P. De Grauwe, D. Gros, ''A new two-pillar strategy for the ECB'', cit., pp. 12-15.

[581] Financial Times, Five reforms the ECB should embrace, https://ftalphaville.ft.com/2018/10/15/1539576001000/Five-reforms-the-ECB-should-embrace/, published on the 15th October 2018, published on the 29th November 2018.

Central Bank. They should be part of the process for improving the functioning of monetary policy so as not to introduce unnecessary volatility in the European markets[582].

Since the Financial Crisis on, the ECB has gradually emerged as the most central and powerful supranational institution within the European and Eurozone framework. Central Bank's independence is one of the keystone in the monetary policy. Despite this, its legitimacy in taking some actions has been enormously put into question, especially in dealing with the Greece' adjustment program through the Troika, during the financial crisis[583].

In contrast to the past, the ECB has gradually improved and strengthened its accountability – the political and legal obligations to explain to Eurozone citizens and their representatives the decisions taken - due to the new tasks acquired through Banking Supervision and advisory role in financial support through the Troika membership. This is, indeed, confirmed by the increased frequency and intensity of exchanges and interactions between the European Parliament and the Central Bank over monetary policy aspects, where the «Monetary Dialogue» stands as the most credible expression to explain ECB decisions on monetary policy and policy agenda[584]. Surely, it allows the ECB to clarify its policy actions within its mandate, considered the keystone of its credibility and legitimacy[585].

Since accountability and independence stands as two sides of the same coin, ECB – in line with art. 284 TFEU and art. 15 of the Protocol - even adopted a series of new channels and instruments, i.e.

---

[582] G. Claeys, ''How should the European Central Bank ''normalise'' its monetary policy'', cit., p. 15.

[583] The Troika, composed by European Commission, IMF and ECB, is entitled to design ''appropriate'' structural adjustment reforms in exchange of financial assistance. Initially, ECB membership was considered necessary for providing adequate financial stability within the Eurozone, especially with regards to banks. However, the ECB has continued to keep its place, which has contributed to undermine ECB's popularity and reputation due to the unsustainability of the programme. Moreover, participating in negotiations and supervision over structural reforms seem a competence that goes far beyond the ECB's mandate (in terms of independence). Financial Times, Five reforms the ECB should embrace, cit.

[584] According to art. 284(3) TFEU, «the European Central Bank shall address an annual report [since 1999] on the activities of the ESCB and on the monetary policy of both the previous and current year to the European Parliament, the Council and the Commission, and also to the European Council. The President of the European Central Bank shall present this report to the Council and to the European Parliament, which may hold a general debate on that basis». However, in the past, the European Parliament (EP) did not focus excessively on monetary policy aspects. It is only over the last two legislative terms, that the EP started proposing its own report and amendments over the monetary policy decisions, probably thanks to an increasing number of experts over technical and financial issues, while the EP Resolution on the ECB annual report is increasingly used to communicate with the ECB. Moreover, ECB publishes also its feedback on the EP Resolution, which surely allows to improve the exchanges between the two institutions over issues, such as decision-making procedures and activities. N. Fraccaroli, A. Giovannini, J. F. Jamet, Accounting for accountability at the ECB'', https://voxeu.org/article/accounting-accountability-evolution-ecb-s-accountability-practices-during-crisis, published on the 4th October 2018, consulted on the 29th November 2018.

[585] The ECB acknowledges its accountability as the necessary counterpart to its political independence in taking decisions and using instruments for fulfilling its mandate without acting over arbitrariness. As a result, besides art. 284(3) TFEU, also art. 15 of the Statute of the ESCB, stressed the ECB's duty to «publish reports on the activities of the ESCB at least quarterly […] and address an annual report on the activities of the ESCB and on the monetary policy of both the previous and the current year to the European Parliament, the Council and the Commission, and also to the European Council».

«Monthly Bulletin» and «Consolidated financial statement of the Euro-system», for improving communication over its strategy and decisions[586]. Nonetheless, despite the increased accountability confirmed also by the frequency of appearance before the European Parliament, two problems still remain: (1) changes concerning the Treaty framework have not occurred and (2) if the European Parliament is not satisfied with the ECB actions and manoeuvres, no measures can be taken, since the ECB's conduct can be only challenged by the European Court of Justice (ECJ) and the Ombudsman[587]. The ECB is still less accountable for its actions and more independent and has a stronger legal status than other central banks do, such as the US Fed Reserve, even though certain legal limits remain[588].

To worsen, the ECB and especially, its Governing Council, have gradually acquired such an increasing power since the Big Financial Crisis that no institution within the Eurozone can counterbalance and match it[589]. This aspect is also confirmed by the veil of secrecy and confidentiality that protects the

---

[586] Since 1999, ECB started releasing its Monthly Bulletin, for a total of eight times per year, with the aim of presenting economic, financial and monetary decisions taken. Likewise, it started issuing a consolidated financial statement for the describing the European balance sheet in terms of Euroarea assets and liabilities. Finally, ECB even started holding press conference after its monetary policy's meetings. Surely, these measures help increasing ECB's transparency and accountability. ECB Economic Bulletin, N. Fraccaroli, A. Giovannini, J.F. Jamet, ''The evolution of the ECB's accountability practices during the crisis'', V (2018) https://www.ecb.europa.eu/pub/economic-bulletin/html/eb201805.en.html#IDofArticle1, consulted on the 30th November 2018.

[587] After the crisis, even though the ECB was entrusted with new tasks through the Single Supervisory Mechanism (SSM) in 2014, the Treaty provisions have not amended. Rather the SSM Regulation was adopted, within the current legal framework, simply by extending the scope of ECB's action and accountability. Furthermore, for providing more accountability to the ECB, also an Interinstitutional Agreement between the Parliament and ECB, accompanied by a Memorandum of Understanding (MoU), were adopted for simply extending its range of actions and providing some channels for accountability over supervisory issues. The ECB accountability can be only examined by the ECJ and challenged for damages, according to art. 340(3) TFEU, or annulling an ECB's action in case of illegality, according to art. 263 TFEU. Similarly, the Ombudsman can be involved in matters on transparency. ECB Economic Bulletin, N. Fraccaroli, A. Giovannini, J.F. Jamet, ''The evolution of the ECB's accountability practices during the crisis'', cit.

[588] The Federal Reserve is accountable both to the public and to the US Congress since transparence is considered as a key principle. As a result, the FED delivers reports over past and future developments and decisions on monetary policy. Similarly, FED is held both transparent and accountable for banking and financial supervision. Hence, it is often testified before the Congress while an annual report, over the activities of the Board of Governors and Banks' activities, is submitted to the Congress as well. On the contrary, the financial accountability is verified by an independent and outside body. Lastly, to be more transparent, the FED publishes weekly its balance sheet. Federal Reserve, Is the Federal Reserve accountable to anyone?, https://www.federalreserve.gov/faqs/about_12798.htm, updated on 1st March 2017, consulted on the 18th November 2018.

[589] In 2015, the President of the ECB launched the QE claiming that the ECB would have started creating money by buying financial assets and bonds, initially until March 2017, for then extending until December 2017. However, a new announcement occurred in October 2017 stressing that ECB would have made monthly purchases of 30 billion euro until September, for reducing to 15 billion between October and December 2018. From the end of September 2018 - beginning of 2019, the QE Programme will be suspended, as Mario Draghi announced on the 14th June 2018. Hence, through the QE, a financial dependence all over Eurozone countries has emerged while social, financial and macroeconomic consequences have surely exceeded the

ECB's documents to the extent that the ECB is free to choose what and when to release its information[590]. This raises claims over a *democratic deficit* and need of more parliamentary scrutiny, especially in time of crisis due to the unpredictability of the events. Indeed, this strict confidentiality makes very difficult to monitor and assess ECB's accountability as very little room is left for public discussion and debates, preventing the European Parliament from stopping an eventual political decisions[591].

Indeed, in time of crisis, it became extremely difficult to evaluate ECB actions due to the complex framework and conditions, in which it was moving, and the new tools adopted. Yet, the Court of Justice has somehow justified ECB's action by *de facto* broadening the interpretation of the ECB's mandate and opting for a very light-touch legality review[592].

Surely, the ECB reacted promptly to challenges presented by the crisis but being the ECB indispensable for the European economy, it is necessary to make the ECB the most transparent and democratically accountable institution as possible - it being sheltered from politicians and from sanctions[593].

Transparency - which is recognized as a citizen's right to participate more closely in the decision-making process - and accountability should be considered in relation to one another. Hence, the increased accountability and transparency, which remain in any case limited, should be evaluated not only upon the increasing interactions with the European Parliament but also upon establishing new legal provisions, which are absolutely required[594]. Indeed, since the European Parliament lacks legal

---

conventional monetary policy. Ryan, ''Is the European Central Bank too big to succeed?'' in J. Ryan and L. Hoffman-Axthelm, ''The Future of the European Central Bank'', *LSE Ideas*, VI (2018), pp. 4-8.

590 Art. 23 of the Rules of Procedure of the European Central Bank acknowledges the confidentiality of the ECB's documents. Preserving the secrecy is necessary for sheltering the political independence of the ECB from national pressures. However, this confidentiality is now extended also to other bodies created, such as the SSM.

591 An Interinstitutional Agreement has been achieved between the ECB and the EP for clarifying more specific rules for a more intense accountability over the ECB while assessing «special confidential meetings». Nonetheless, the level of secrecy is still so high that a public and open discussion is still impossible. Interinstitutional Agreement between the European Parliament and the European Central Bank on the practical modalities of the exercise of democratic accountability and oversight over the exercise of the tasks conferred on the ECB within the framework of the Single Supervisory Mechanism, Official Journal L320 [2013].

592 See European Court of Justice, *Gauweiler and Others*, Case C-62/14, [2015], section «Proportionality».

593 Surely, great efforts have been achieved since besides the annual report, the ECB has created a Compliance and Governance Office, operating as a channel for transparency. Similarly, it has also started publishing information over its QE purchases, which is desirable since by buying bonds ECB might prefer multinational corporations over the SMEs. L. Hoffman-Axthelm, ''Institutional Loneliness: how to fix conflicts of interest at the ECB'', in J. Ryan and L. Hoffman-Axthelm, ''The Future of the European Central Bank'', *LSE Ideas*, VI (2018), p 15.

594 Since the beginning of its existence, the ECB has provided some public access to its document. Still within the meaning of Decision ECB/2004/3, «the ECB shall refuse access to a document where disclosure would undermine the protection of: (a) the public interest as regards the confidentiality of the proceedings of the ECB's decision-making bodies; the financial, monetary or economic policy of the Community or a Member

powers and is in a institutionally weak position to hold the ECB, the duty of the latter to present itself before the EP seems more a sort of answerability rather than a real accountability[595].

As a matter of fact, even though these improvement are highly desirable, a more demand for parliamentary and democratic scrutiny is needed for four main reasons since ECB policy-making has been sometimes controversial and political: (1) fostering public trust which is a requirement for keeping Central Bank's political independence[596]; (2) being accountable to the Eurozone-countries and citizens; (3) improving transparency not only in the context of monetary policy but also over rules on the composition of the advisory groups member and understanding over financial and economic relations, and especially over its lobbying activities and relations, as it is also asked by the European Parliament[597]; and (4) verifying whether ECB is actually operating within its mandate[598].

The main problem in reversing and further improving transparency and accountability of the ECB is also related to the defensive position that the Central Bank has adopted, accompanied by a very narrow interpretation of its Statute when more suitable for the Bank[599].

State [..]; the commercial interest». Official Journal of the European Union, Decision of the European Central Bank of 4 March 2004 on public access to European Central Bank documents, Official Journal L 80 [2004].

595 The Monetary Dialogue between the European Parliament and the European Central Bank simply ignores the political involvement of the ECB in debt assistance and financial conditionality. Therefore, being the ECB enriched with new tasks, a more comprehensive and holistic approach to the ECB should be advanced. D. Curtin, ''Accountable Independence of the European Central Bank: Seeing the logics of Transparency'', *European Law Journal*, XXIII, VIII (2017), p. 32.

596 According to the Eurobarometer, trust in the ECB has gradually recovered, with the exception of Greece, with a 69% mistrust. Hence, the more the ECB communicates with the EP, the more its credibility increases. Eurobarometer, Trust in the European Central Bank, http://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/Chart/getChart/themeKy/9/groupKy/27, consulted on the 29th November 2018.

597 The European Parliament is asking for more transparency with the lobbyist due to the dominance of the private financial institutions. Indeed, most of ECB's advisory group members (98% corresponding to 508 of 517 available seats) who give advices to national banks, are part of private financial institutions and tend to discuss highly sensitive political issues. Moreover, the ECB has no intention to give up on the advice provided by the global private financial institutions and corporate and the private rating agencies on which it relies. What worries is also the fact that most of these advisory group members are not part of the EU Transparency Register and the fact that they might influence decisions by injecting multibillion euro stake for the industry. Corporate Europe Observatory, Corporate capture at its most extreme: 98% of ECB advisors represent industry, https://corporateeurope.org/pressreleases/2017/10/corporate-capture-its-most-extreme-98-ecb-advisors-represent-industry, published on the 3rd October 2017, consulted on the 30th November 2018.

598 The involvement of the ECB in Ireland and Greece during the Eurozone crisis is still debatable and confused since questions whether the ECB acted within its mandate emerged raising claims over legitimacy and accountability. Surely, what is emerged is that Greek bailout programmes with its conditions have put a severe contraction on its economy and growth due to the conditions imposed on Greece. Indeed, Troika and especially, ECB's decisions seemed more a punishment for the government's profligacy and for damaging the banking system to the extent that ECB emerged as an untrustworthy and authoritarian institution. J. Ryan, ''Is the European Central Bank too big to succeed?'' in J. Ryan and L. Hoffman-Axthelm, ''The Future of the European Central Bank'', *LSE Ideas*, VI (2018), pp. 5-6.

599 The ECB continues to maintain a very defensive approach over increasing its transparency stressing that they have already made enormous efforts and demonstrated enough commitment. The ECB claims that activities with external bodies and advisory group relate to gathering information over economic and financial developments with a wide range of stakeholders «within the ECB's "central banking" mandate. Therefore,

Surely, ECB's accountability and transparency is still not sufficient for all the powers it has acquired since the financial crisis, which puts also into question the credibility of its independence, being extremely involved in certain political actions, as the Troika[600]. Indeed, the ECB's secrecy and power come at the expense of national parliaments while modalities of ECB's participation in the Troika and the information ECB gets for the decision-making process in debt assistance still remain unknown. A similar approach seems to exceed the level of democratic accountability needed while it stressed that the ECB is more in control than under control[601].

ECB's independence might be more reliable with a more precise and detailed mandate and with an ECB acting really within its mandate, even though the ECB's overexposure during the crisis has been a direct consequence of the unstable and inefficient EMU's framework. If ECB intends to act beyond its mandate, in exceptional cases such as a financial crisis, then a mechanism under the European Parliament for providing political buy-in and legitimacy to ECB's actions would be appropriate. At least, these actions might be acknowledged as necessary and would entitle ECB to act beyond its mandate. Surely, what has emerged is the fact that the ECB does not fear the European Parliament or what it can do because the latter does not have enough legal powers to proceed with a concrete action. Indeed, an equal economic and political counterpart for counterbalance ECB does not exist[602].

PART THREE

Refocusing Eurozone Fiscal framework: Overcoming the complex nature

3.3. The Dilemma of Eurozone Fiscal Union: The impossible solution

The Economic and Monetary Union is undoubtedly the greatest example of cooperation and peaceful integration ever experienced in the human history. Even though it has represented and continues to be an incredible project, it might have been extremely ambitious.

The 2008 economic crisis represents the most devastating event that seriously hampered both stability and survival of the Eurozone, many steps have been taken, in the banking and fiscal field, since then

---

the contact groups have no relation to the ECB's banking supervision mandate». ECB, Letter from the ECB President to several MEPs on ECB's interactions with external parties, https://www.ecb.europa.eu/pub/pdf/other/ecb.mepletter180123_s_d_meps.en.pdf?d48b2fb5f260b36bb72a8812753e1e28, consulted on the 30th November 2018.

600 Besides the Troika, the ECB has exerted excessively political influence. In August 2011, both the Prime Ministers of Spain and Italy received two secret letters by the former President of the ECB, Jean-Claude Trichet. These letters were sent soon after the ECB started buying their bonds stressing that ECB would have continued supporting both countries provided that Italy and Spain adopted economic, fiscal and structural measures. Similarly, Greece received a warning that it would have been excluded from financial assistance, if the country had continued to ask for debt rescheduling.

601 D. Curtin, ''Accountable Independence of the European Central Bank: Seeing the logics of Transparency'', cit. pp. 41-42.

602 L. Hoffman-Axthelm, ''Institutional Loneliness: how to fix conflicts of interest at the ECB'', cit., p. 16.

by transferring further sovereignty in a short-time period. The provisions adopted contributed to overcoming the Big Financial Crisis and strengthening the institutional framework. Yet, still ameliorations are needed to implement and enhance Eurozone's stability.

Proposals over the necessity of creating a Fiscal Union as an additional adjustment mechanism have been advanced[603]. Its creation is envisaged as the solution for complementing the EMU framework through a financial stabilization function while cushioning macroeconomic shocks through a Fiscal Policy Board and a common budget[604].

The proposed Fiscal Union stands (once again) as a far-reaching and ambitious project which is both politically and legally unfeasible besides the fact that it is not recommended on two main grounds: (1) institutional unpreparedness of Euro architecture being Banking Union uncomplete and deprived of a European Deposit Insurance System (EDIS) and (2) the lack of consensus and solidarity among European citizens[605].

Fiscal Union is simply impossible as it would require to transform the current Economic and Monetary Union in a more solid political union by integrating fiscal policies and shifting more spending from national to European level. Yet, it requires a level of political trust and accountability in times when Europe is faced by several challenges, such populism and Brexit negotiations.

Fiscal Union – even though conceived for addressing structural deficiencies and inefficiencies - requires to reshape relationship between national and EU Treaties by overcoming not only EU objections but also national oppositions as it would need amendments of the Treaties to shift fiscal competences from national to EU level[606].

---

[603] Fiscal union has different meanings in the economic and policy literature which moves from the idea of creating common fiscal policies to transferring both tax and public spending at European level. Generally speaking, fiscal union is intended as a transfer of fiscal resources and national competencies in fiscal policies from the domestic sphere to supranational one. Concerning EMU, fiscal union can be interpreted as any attempt to further centralise fiscal policies. G. Thirion, ''European Fiscal Union: Economic rationale and design challenges'', cit., p. 3.

[604] The proposal on the creation of a fiscal union was launched in the ''The Five President's Report: Completing Europe's Economic and Monetary Union'', in section IV ''Towards Fiscal Union - an Integrated Framework for Sound and Integrated Fiscal Policies''. This plan envisages the creation of a financial stabilisation function and an advisory European Fiscal Board that «would coordinate and complement the national fiscal councils that have been set up in the context of the EU Directive on budgetary framework. It would provide a public and independent assessment, at European level, of how budgets – and their execution – perform against the economic objectives and recommendations set out in the EU fiscal governance framework». J.C. Juncker, D. Tusk, J. Dijsselbloem, M. Draghi and M. Schulz, ''The Five Presidents' Report: Completing Europe's Economic and Monetary Union'', (2015), pp. 14-15.

[605] Talking about fiscal union is impossible since solidarity and support are lacking. Moreover, European policy is weakened by Euro-skeptism-populism that would impede from sharing more obligations, i.e. strict budgetary rules, discipline and reforms. Finally, EMU is composed of sovereign states that want to preserve their history and their identities, which make quite impossible for Eurozone countries to give up also their fiscal policy, a pure outcome of sovereign state history. M. M. Cózar, ''The only feasible fiscal union for the euro area'', *European View*, XVI, I (2017), p. 28.

[606] F. Behre, ''Fiscal Union – or the legally impossible task to stabilize the Euro'', PhD Research Paper, University of Leiden, Europa Institute, 2017, p. 3.

From a legal point of view, fiscal integration not only enters into conflict with the «*principle of conferral*» but considering the current legal framework, the Union is in charge only of monetary matters[607]. Hence, fiscal union involves political implications, such as further loss in terms of political powers (budget spending) and loss of national democratic decision-making as citizens have the power to scrutinize political decisions.

Attributing also fiscal competences to the EMU raises doubts about legitimacy of this action intended to further integrate and centralize specific competences. Moreover, risk of failure in amending the Treaty for creating a Fiscal Union also could seriously compromise credibility, unity and stability of the European Union whose effects could even impact financial markets[608]. Besides this, the creation of a Fiscal Union should be supported by an *ad hoc* legitimate institution with an appropriate mandate (being fiscal competences a core aspect of the democratic decision-making process).

As a result, assigning also fiscal competences could raise a problem of democratic deficit and ignore appropriate democratic safeguards. Hence, the creation of the European Fiscal Union could be challenged by national constitutional courts contesting the expanding fiscal competences since fiscal integration might affect constitutional identity, sovereignty and democracy while conflicting with national principles[609]. Different constitutional developments might prevent or allow further integration leaving open questions over the feasibility of the Fiscal Union[610].

---

[607] According to art. 4 and art. 5 TEU, the Union «shall act only within the limits of the competences conferred upon it by the Member States in the Treaties» implying that the Union cannot empower itself to act in other fields. Expanding the competences would absolutely require amendments since fiscal policies are not a competence of the EU. Surely, economic issues are coordinated at European level but the ultimate responsibility for economic policies still lies in the member states.

[608] Art. 48 TEU requires unanimity and ratification of all the Member States (not only the Eurozone countries). The United Kingdom could be still included in this ratification process due to its voting right. Indeed, it is expected to leave the European Union only on the 29th March 2019. Hence, being in times of Brexit with its intricate and complicate negotiations, the UK could veto the possible amendments. Should the European Union opt for amendments, it is highly recommended to wait until Brexit is finalized.

[609] The creation of the European Fiscal Union could be challenged by national courts with different outcomes. For instance, the German Federal Constitutional Court (Bundesverfassunggericht) is famous for its prominence in the European Union Law. It has, indeed, developed a very specific interaction between German legal framework and European law. Art.79(3) of the Basic Law acknowledges the inadmissibility of amendments of basic law «affecting the division of the Federation into Länder, their participation in principle in the legislative process, or the principles laid down in Articles 1 [with regards to human dignity] and 20 [Constitutional principles – Right of resistance] shall be inadmissible». Hence, the Court intends to preserve German principles as they are (against further expansion of competences). Deutscher Bundestag, Basic Law for the Federal Republic of Germany, [2017]. Moreover, in times of crisis, under the *Bve 2/08 Lisbon Decision (Lissabon-Urteil),* «fundamental fiscal decisions on public revenue and public expenditure» shall under the German Bundestag (par. 252 and 256) prevent any fiscal transfer from national to European level. BVerfG, Judgment of the Second Senate of 30 June 2009 - 2 BvE 2/08 (*Lisbon Decision*). From a German legal point of view, fiscal union seems simply impossible to be achieved as new provisions would require either abolition or amendments of art. 79 of Basic Law.

[610] In contrast to Germany, the Finnish Constitution (with Finland joining EU in 1995 and Euro in 1999) shows a much more open approach to new developments and flexibility in transferring powers. Under section 94 [Acceptance of international obligations and their denouncement], an alteration of the constitution can occur through a decision made at least by two thirds of the votes cast. According to this Finnish provision, the

Legal limits - European and national - pose severe challenges to the creation of this new mechanism putting into doubt and question the project on fiscal integration.

Opting for a multispeed European Union, where Member states willing to proceed towards a further integration can do it while leaving apart those reluctant, is not a desirable option for two main considerations[611]. First, it would risk to increase deficiencies and inefficiencies within an already imperfect system and secondly, it could undermine solidarity and credibility among the EU Member States. Encouraging fiscal integration seems simply an inefficient and unfeasible option and leaving quite uncertain future on the creation of Fiscal Union. Political integration has its own weaknesses as countries are extremely heterogeneous in their economic and fiscal policies[612].

Since the establishment of Maastricht Treaty (1992), there have been a series of attempts to centralize fiscal policies by implementing the Stability and Growth Pact (SGP) with initiatives and fiscal packages to maintain sound finances, being fiscal profligacy perceived the greatest risk in the monetary union. Yet, Six Pack, Two Pack and the European Semester have been the wrong response to satisfy all the different fiscal preferences of the Euro-Area countries[613]. Therefore, if centralization in fiscal policies has never really attracted the attention of Eurozone leaders, it is highly improbable it will be different in the future. Fiscal union might be simply resisted and contrasted[614].

Creating a Fiscal Union among the Eurozone countries is simply impossible as it creates further distortions and shocks. The European Commission should simply acknowledge that EMU and Eurozone countries have different preferences for fiscal policies to the extent that the costs of fiscal integration and fiscal uniformity are simply too high.

The idea of centralizing fiscal policies, taxation and spending, should be simply abandoned as it is something illusory and fictitious. Fiscal policy is the only stabilization mechanism for the Eurozone countries in the absence of an autonomous monetary policy and exchange rate[615].

Fiscal Union might see the light. Ministry of Justice, Finland, The Constitution of Finland, (731/1999, amendments up to 1112 / 2011 included), [1999].

611 In 2017, the European Commission released its «White Paper on the Future of Europe». One of the potential future scenarios conceives the idea of «those who want more do more» suggesting that countries that are willing and ready to do it can deepen cooperation in a wide range of issues (security, taxation, social matters, working conditions). Opting for an increasing multispeed Europe might be detrimental to the original plan of cohesion, cooperation and solidarity, sanctioned in the Treaties. European Commission, ‘’White Paper on the Future of Europe, Reflections and Scenarios for the EU27 by 2025’’, COM(2017)2025 [2017], p. 20.

612 M. Demertzis, G. Wolff, ‘’What are the prerequisites for a euro-area fiscal capacity?’’, cit. p. 5.

613 The Stability and Growth Pact is not limited to euro-area members but it is extended to all the European Union countries. Nonetheless, Eurozone countries can affect much more the stability of system than the others. Most member states have failed to meet the conditions and targets imposed by the SGP, starting from 2003 with France and Germany, being unpunished. Only Luxembourg, an Eurozone member, and Sweden, a non-Euro member, satisfied always the conditions. Surely, it is quite unknown what would have happened if conditions and criteria had been always respected.

614 B. Eichengreen, C. Wyplosz, ‘’Minimal Conditions for the survival of the euro’’, cit., p. 40.

615 The idea of centralising part of national budgets (national taxation and spending) into a common budget supervised by a common political authority seems an unrealistic solution. Political consensus is, indeed, lacking. Centralizing common budget might increase not only national budget deficits but also the European

The Global Crisis highlighted that financial stability and financial integration should be carried out in the Eurozone. Yet, even though few common elements for fiscal policy might be desirable, the only version of fiscal union that can be achieved would be a limited one. Few purposes and main priorities can and should be established in the Euro-area to complement a better and smooth functioning of the monetary policy: (1) the creation of a fiscal backstop, under the European Deposit Insurance System (EDIS), for completing the Banking Union; (2) the creation of mechanisms for ensuring a fiscal stabilization; (3) decentralizing the current centralization of certain fiscal policy or at least, improving the current framework.

Before raising considerations on moving towards fiscal union, the current framework should be enforced. Indeed, Eurozone shall be well-equipped with appropriate and effective instruments to shelter Euro-countries from adverse and asymmetric shocks. What is evident is the incompleteness of the current monetary union. Therefore, consolidating the system, , shall be the main priority. A fiscal union would not necessarily improve the Eurozone and rather, it could even worsen the business cycles asymmetries[616].

3.3.1. Reforming the Eurozone Fiscal Framework: Changing the targets, improving the system

The existence of the Euro and the survival of the Economic and Monetary Union can and should be safeguarded provided that Eurozone is improved. Creating a currency area that works and ensures more prosperity and growth is feasible but it requires the adoption of political decisions and also improvements in what has been achieved so far[617].

Since the founding of the Economic and Monetary Union and the launching of Euro, Eurozone countries decided to guide feasible externalities of their economies by introducing the Growth and Stability Pact (SGP), in 1997. Not only did it impose numerical restrictions on national fiscal policies, especially debt and deficit levels, but it has also been repeatedly violated without enforcing serious and strict restrictions.

The SGP should be applied in a much more flexible way to business economic cycles. For instance, rather than opting for complex and rigid rules, national adjustment accounts should be properly analysed and eventually, incremental investment and unemployment spending should be shifted from bad to good times.

---

one. A common budget might enhance intra-country transfers, where countries experiencing a recession could get the most benefits (having access to stabilizing force) while countries in a good equilibrium could be contaminated. P. De Grauwe, Y. Ji, ‘’How to reboot the Eurozone and ensure its long-term survival’’, in R. Baldwin and F. Giavazzi (edited by) *How to fix Europe's monetary union,* London, CEPR Press, (2016), cit. p. 143.

616 M. M. Cózar, ‘’The only feasible fiscal union for the euro area’’, cit. p. 30.

617 J. Stiglitz, *The Euro: How a Common Currency Threatens the Future of Europe,* New York, Norton & Co Inc., 2016, p. 168.

Before the crisis, one of the main weaknesses of the Euro-architecture was the absence of a tool for monitoring macroeconomic imbalances. Inevitably, fiscal rules were inadequately enforced while insufficient attention was given to both public debt accumulation and persistent divergences[618].

Since the Big financial crisis, where one of the triggering factors was fiscal indiscipline, Eurozone leaders have introduced a series of reforms to improve fiscal surveillance under the supervision of the European Commission and European Council: Two-Pack, Six-Pack, and Fiscal compact[619]. Yet, none of these have actually led to an increase in compliance and rules' enforcement. Rather, they have simply added more complexity to Eurozone fiscal framework adding escape clauses and exceptions and making the system less transparent and difficult to comply with. Moreover, fiscal rules are weakened by lack of credibility and inefficient flexibilities[620].

When the Euro was launched, fiscal impulses and policies were expansionary in upturns while incentives to curb government debt and promote contractionary policies in downturns were absent.

European fiscal rules are failing in supporting national economies not providing the effective stabilization and stability needed within a monetary union[621]. As a matter of fact, Eurozone

---

[618] At the beginning of the crisis, main problems were not only associated to macroeconomic imbalances but also to pro-cyclical fiscal policies between 2011-2013, which did not halt Eurozone economic deterioration, public investments collapse and cuts in expenditures. To worsen the situation, no serious measure had been taken for containing wage and price divergences among the main countries: France, Germany and Italy. Even though structural reforms, which found a strong political opposition, were adopted, an adjustment mechanism for guiding Euro-area wide demand is still lacking. A tool for identifying and addressing the macroeconomic imbalances known as the Macroeconomic Imbalances Procedures (MIP) has been introduced only in 2011, once it was acknowledged that imbalances in one country can affect another one. The only mechanism present before the crisis was the Excessive Deficit Procedure (EDP) that allows the European Commission to take actions, whenever a country exceeds the budget deficit ceiling imposed by the SGP. A. Sapir,G. Wolff, ''Euro-Area Governance: What to reform and how to do it'', cit., pp. 2-4.

[619] The SGP was reformed in 2005. Yet, new fiscal provisions have been adopted: Six-Pack (2011), Fiscal Compact (2012) and finally, Two Pack (2013). The current fiscal framework includes: (1) a budget deficit below 3%; (2) a gross public debt below 60% and if higher, it must decline annually; (3) a structural budget balance that shall meet the country specific medium-term objective (MTO) and shall not exceed a deficit of 0.5% GDP or 1% for those countries with a debt-to-GDP ratio below 60% and (4) adjustment of real government expenditures, which cannot grow faster than the medium-term potential growth.

[620] SGP are subjectto three kinds of flexibilities during a downturn: (1) under the *preventive arm*, countries may decelerate their adjustment efforts when hit by negative economic shocks, depending also on numerical limits; (2) under the *corrective arm*, countries might redefine their adjustment under the supervision of the European Commission and (3) *exceptional circumstance* might be invoked, if a euro-area country is exposed to significant bad times and downturns. Similarly, Fiscal Compact acknowledges *a temporary deviation* (in line with the *preventive arm* of the reinforced SGP) according to which a country may deviate from its medium-term objective only in exceptional cases, for example when there is an event beyond the control of the country. (France is expected to deviate from 3% deficit ceiling in 2019, as the French President Emmanuel Macron said). Even though these flexibilities might be welcome, they do not eliminates the pro-cyclical impact of the EU policies. Moreover, countries complying with the SGP cannot benefit from flexibility. Therefore, if the Euro area faces a negative shock, there is no instrument to bind those countries (that comply with SGP) to implement expansionary policies. A. Bénassy-Quéré, X. Ragot, G. Wolff, ''Which fiscal union for the Euro-area?'', *CAIRN – Conseil d'analyse économique,* XXIX, II (2016), p. 9.

[621] Current fiscal rules consist of numerical constraints on government's fiscal policy that basically set numerical limits on finances, expenditures, revenues and budget. Hence, they hinder government actions and policies.

governments rely excessively on ECB monetary policy, which is becoming a real-overburden for Eurozone economy being incapable of fostering growth and recovery.

A more active role of fiscal policies in time of crisis and economic shocks could help stabilize national economies since the current fiscal rules have only exerted a pro-cyclical fiscal effect pre- and post-financial crisis. From 2010 on, they have also applied a pro-cyclical fiscal tightening that resulted in higher unemployment and recession.

A better designing of the current fiscal framework is undoubtedly needed for three main reasons: (1) improving European fiscal rules for mitigating fiscal excesses; (2) establishing automatic stabilizers adjustment mechanisms at Eurozone level and (3) a serious commitment to robust growth and full employment[622].

The current European fiscal framework and its enforcement are - both in practice and in theory - highly ineffective. There are too many rules in place that are further complicated by the multiplicity of exception clauses and escape clauses[623]. Hence, they are very ineffective in ensuring sustainable public finances.

On the one hand, current fiscal rules - focused on a 3% structural government deficit and 60% government-debt-to-GDP - contribute to Eurozone deceleration and do not provide the needed stimulus. On the contrary, they foster a pro-cyclical effect rather than a countercyclical one to the extent that a growth-oriented policy is quite impossible. For certain counties, i.e. Cyprus, Spain, Portugal, Italy, Finland, Belgium and Lithuania, violating the 3% threshold is inevitable for fostering domestic consumption and production as it implies an increase in spending in the lack of investments[624]. On the other hand, Macroeconomic Imbalance Procedure (MIP), introduced in 2011, is the only available mechanism for ensuring that wages are in line with productivity. Nonetheless, it is still too weak for ensuring convergence and competitiveness[625].

The current fiscal rules do not only lack credibility but they are also unable to provide the required level of fiscal stabilization and sustainability[626].

Moreover, if policies are not well-designed, they might become a source of instability and pro-cyclical fiscal policies. The European institutions and especially, the Commission, are entitled to monitor and evaluate fiscal policies as they influence wage and price divergences. Introducing inflationary and deflationary fiscal policies might influence the average-euro area inflation, thus resulting in monetary easing or tightening. Z. Darvas, P. Martin, X. Ragot, ‘’European fiscal rules require a major overhaul’’, *Bruegel policy contribution*, XVIII, X (2018), p. 2.

[622] G. Claeys, ‘’The missing pieces of the Euro architecture’’, cit., pp. 11-12.

[623] Compliance is extremely weak as in most cases Euro-countries exceed fiscal rules’ threshold. In addition to, fiscal rules lack an efficient and proper enforcement mechanism as flexibility has prevailed over sanctions, even though after 2008 all the Euro and non-Euro countries underwent the Excessive Deficit Procedure (EDP). Z. Darvas, P. Martin, X. Ragot, ‘’European fiscal rules require a major overhaul’’, cit., pp. 6-7.

[624] D. Papadimoulis, The Stability And Growth Pact Has Failed, https://www.socialeurope.eu/stability-growth-pact-failed , published on the 7th November 2016, consulted on the 20th November 2018.

[625] A. Sapir, G. Wolff, ‘’Euro-Area Governance: What to reform and how to do it’’, cit. pp. 4-5.

[626] The current fiscal rules are not credible and tend to be both politically and economically counterproductive. One of the main problems is related to the fact that by applying financial penalties, they only serve a purpose

Fiscal rules are undoubtedly needed for controlling Eurozone government behaviour and preventing inappropriate fiscal policies and insolvency risks. However, preserving the current fiscal framework, is extremely dangerous and harmful. Despite the adoption of new packages, the SGP has led to excessive public debt accumulation and has hindered a well-functioning macroeconomic stabilization[627].

Fiscal rules can be used to mitigate excessive imbalances and avoid discretion provided that they establish a good balance and equilibrium between three key principles: (1) *Simplicity* to anchor expectations of financial sustainability and strengthen fiscal rules' effectiveness; (2) *Flexibility*, for applying changes in fiscal policy, when needed and (3) *Enforceability*, for applying suitable and stringent measures on irresponsible governments[628].

A revision of the fiscal framework would be absolutely needed to correct the current highly complex, opaque and difficult framework. To worsen, both the Stability and Growth Pact (SGP) and the Macroeconomic Imbalance Procedure (MIP) are asymmetric and targets only countries with an excessive deficits - without considering sufficiently countries with significant surpluses - while imposing restraints on fiscal behaviour[629].

Any Eurozone country with a very large surplus or deficit poses a serious risk for the whole stability of the Euro-area. Therefore, they should be discouraged and contained being a source of divergence[630]. To keep structural balance and reduce heterogeneities, surplus countries should increase raise minimum wages while applying expansionary fiscal policies[631].

---

of penalisation. Enforcement is based on a constant threat of fines, which do not fulfil any economic purposes except punishing rules' violation. A similar approach and framework simply endanger and worsened an already weak fiscal situation. Fines lose, in this way, their credibility. A. Bénassy Quére and co., ''Reconciling risk-sharing with market discipline: a constructive approach to euro area reform'', cit., p. 3.

[627] The 60% debt-to-GDP and the 3% deficit rule have directly affected the level of both macro and micro relevant fiscal factors, including nominal budget balance, public debt, deficit, nominal expenditures. Complexity of a similar system has simply compromised the economic state of the Eurozone countries. A. Bénassy Quére and co., ''Reconciling risk-sharing with market discipline: a constructive approach to euro area reform'', cit., p. 3.

[628] X. Debrun, L. Eyraud, A. Hodge, V. Lledo, C. Pattillo, Second-generation fiscal rules: From stupid to too smart, https://voxeu.org/article/second-generation-fiscal-rules-stupid-too-smart?utm_source=GDPR&utm_campaign=e693d7b482-EMAIL_CAMPAIGN_2018_09_14_09_34&utm_medium=email&utm_term=0_7c51e322b7-e693d7b482-278644353, published on the 22nd May 2018, consulted on the 21st November 2018.

[629] One of the main problems in the current fiscal framework concerns deviations from deficit. A country, such as Germany, can continue conducting restrictive fiscal policies while enjoying benefits and trade surplus, without the need of applying spending cuts. Since 2011, Germany is constantly violating the maximum level of trade surplus - 6% annually under the MIP – having reached the peak in 2015 with 8.8%. In doing so, competiveness in the Eurozone is highly endangered. D. Papadimoulis, ''The Stability And Growth Pact Has Failed'', cit.

[630] Regulation No 1176/2011 (establishing the MIP) provides the legal basis for monitoring both current account surpluses and deficits, even though current accounts are treated asymmetrically. According to the European Commission report, «large stocks of foreign assets and current account surpluses do not raise comparable risks, but deserve monitoring as they are the counterpart of external liabilities and deficits». Thus, even though surplus receive more attention from a point of view of macroeconomic surveillance, art. 4(2)

The current fiscal policy is enormously destructive and damaging for three main reasons: (1) Both social cohesion and support decrease since countries are treated differently; (2) Numerically speaking, fiscal rules are too strict and intrusive and are even made worse by the revision made through the European Fiscal Compact, through the introduction of the structural deficit – not exceeding 1% of GDP - that ignores cyclical fluctuations and the enforcement of the balanced budget rule and (3) these fiscal rules are poorly designed and not country-tailored, underestimating adequate responses and resulting in a counterproductive catastrophe[632].

The only choice is adapting the current rules to encourage countercyclical policies while ensuring long-term sustainability. Correction of imbalances (surpluses and deficits), in conjunction with a strong combination of both monetary and fiscal policy, is needed for reducing Eurozone indebtedness. Hence, rules should be revised for two reasons: (1) the 3% deficit rule is , imperfect, restrictive and unsuitable for all the Eurozone countries and (2) excessive asymmetric flexibility over the current fiscal framework endangers credibility of the system.

Fiscal rules should be simplified to reduce the reoccurrence of financial crisis and enhance a more sustainable growth. Similarly, the European Commission should abandon the numerical constraints and mathematical formula and rather opt for a more appropriate analysis[633].

Fiscal policies should be more transparent and simple rather than the currently complex and numerous rules. More adequate and flexible targets should operate under the direct control of Eurozone

---

acknowledges that «the assessment of Member States showing large current-account deficits may differ from that of Member States that accumulate large current-account surpluses». Surpluses are not given the same concern and the same urgency of deficit. European Commission, ‘’The Macroeconomic Imbalance Procedure: Rationale, Process, Application: A Compendium’’, *Institutional Paper*, XXXIX (2016), p. 24, p.49, p. 51.

631 Surplus countries, i.e. Germany and France, poses a serious risk for deficit countries, i.e. Spain, Italy, Cyprus, Greece, for the simple fact that according to economic theory, for every surplus there must be a deficit to achieve an equilibrium. In the Eurozone case, there are too many deficit countries that endanger Eurozone stability. Since deficit countries are constrained by trade deficits in achieving full employment, surplus countries should be limited in their surplus while deficit countries should be further supported. J. Stiglitz, *The Euro: How a Common Currency Threatens the Future of Europe*, cit., p. 176-177.

632 After the Great Recession of 2008-2012, the structural deficit rule has been the main focus of Eurozone fiscal framework. In addition to having been introduced in almost all member state legislations, public finances should be now close to the balance over the cycle. Yet, it is extremely difficult to implement a similar rule in year-by-year due to complexities in measurement. The structural budget rule is not only hard to respect but it is also very unstable being subject to revision due to mistakes and errors. Usually, for Core countries, the revision in the structural balance is between a half and 1% of GDP while for the Periphery is even higher. L. Feld, C. Schmidt, I. Schnaebel, V. Wieland, Refocusing the European fiscal framework,https://voxeu.org/article/refocusing-european-fiscal-framework?utm_source=GDPR&utm_campaign=e693d7b482-EMAIL_CAMPAIGN_2018_09_14_09_34&utm_medium=email&utm_term=0_7c51e322b7-e693d7b482-278644353 , published on the 12th September 2018, consulted on the 21st November 2018.

633 Current macroeconomic policies are not growth-oriented and rather restrictive. In this way, investments are collapsing while unemployment is becoming a persistent factor in all Eurozone countries. More efficient structural policies and tailored labour market policies are needed to contrast persisting unemployment, especially the youth one. E. Marelli, M. Signorelli, ‘’Convergence, Crisis and Unemployment in Europe: the need for innovative policies’’, cit., pp. 36-38.

governments. In this way, incentives for introducing countercyclical polices and reducing excessive public debt would be provided.

Adjustments in the current fiscal framework are needed for addressing moral hazard while focusing more on debt sustainability and ensuring reasonable deficit levels. The current 3%-deficit rule imposes severe limits, it being used both in good and bad times and resulting in a pro-cyclical effect[634].

The application of wrong rules based on a fixed and ineffective assumption have simply contributed to spreading a poor economic Eurozone performance and worsening a catastrophic fiscal condition in certain countries.

So as to ensure a well-functioning Eurozone, the main structural differences in the countries shall be recognized and a more flexible fiscal framework should be introduced for accommodating different scenarios. Reacting to non-compliance with fiscal rules by applying austerity and sanctions is simply the worst approach that Europe can apply due to more catastrophic results (higher unemployment, debt, social dissatisfaction and slow growth).

A reorganization might occur through a simple approach so as to respect national sovereignty in fiscal policy and ensure more adequate public debt levels and fiscal sustainability.

For instance, attention might focus on limiting public expenditures on the growth-rate so that it does not exceed both ECB's inflation target (2%) and the country's potential real GDP growth[635]. Being observable and independent from business cycles and wrong predictions that occur through structural deficits, public expenditures can indeed be influenced by governments.

Nominal expenditures should not be allowed to grow faster that long-term nominal incomes while they should grow slower in those countries affected by high debt levels. A similar approach would implies a two-pillar strategy: (1) a long-term debt target amounting up to 60% GDP and (2) an hypothetical «expenditures operational rule», distributed over a medium-term of five years, to achieve the country-debt-target[636].

The *simple expenditure rule* would be based on an accurate economic analysis of the country considered - and not on a formula - focusing on fiscal sustainability and internal economic situation

---

[634] A. Sapir, G. Wolff, ''Euro-Area Governance: What to reform and how to do it'', cit., p.6.

[635] Replacing the current fiscal system focused on structural deficit with *an expenditure rule* might be a more efficient and appropriate response for establishing a well-functioning fiscal framework. Structural deficit is very hard to control and not observable in real time, as estimates are based on assessments of business cycles and its impact on government revenues and expenditures that are revised after one year. On the contrary, expenditures can be efficiently observed. Moreover, an expenditure rule could enhance countercyclical stabilisation for two reasons: (1) increases in cyclical revenues do not impact expenditures ceiling enhancing strong fiscal discipline in a good equilibrium and (2) they do not need revenues losses to counterbalance lower expenditures. A. Bénassy Quére and co., ''Reconciling risk-sharing with market discipline: a constructive approach to euro area reform, cit., p. 10.

[636] L. Feld, C. Schmidt, I. Schnaebel, V. Wieland, Refocusing the European fiscal framework, https://voxeu.org/article/refocusing-european-fiscal-framework?utm_source=GDPR&utm_campaign=e693d7b482-EMAIL_CAMPAIGN_2018_09_14_09_34&utm_medium=email&utm_term=0_7c51e322b7-e693d7b482-278644353 , published on the 12th September 2018, consulted on the 21st November 2018.

(expected inflation, growth and unemployment). Hence, *ad hoc* parameters between the actual country-debt and the long-term target of 60% through a debt-corrector factor would be introduced[637]. By constraining expenditures, the final effect would be a less pro-cyclical fiscal policy while providing a more realistic path towards debt reduction[638].

A similar approach would be preferable for several considerations: (1) Debt levels would be taken into consideration thus generating incentives to reduce debt accumulation towards the long-term threshold. These rules would be less stringent and debt would have to grow at the same rate as GDP to keep a constant debt-ratio; (2) Growth would be supported with deficits as well, providing countercyclical fiscal policy for a general macroeconomic stabilization being nominal growth rate of expenditures not affected by shocks; (3) Excessive booms and deficits would be contained; (4) Cut in public expenditures would be reduced; (5) Fiscal rules should be allowed to reach an upper level, i.e. 5-6% of GDP in a bad recession, since during severe times deficits tend to increase, usually by 3%[639].

A similar approach might ensure both sustainability and stabilization without completely dismantling the current Treaties. Moreover, it would be easier, more transparent and more effective for Eurozone countries as it could guide fiscal policies in a more efficient way.

Not-compliance with new rules should not be applied through penalties and sanctions, currently amounting to up to 0.5% of a country-GDP. The current experience resulted in a real failure and a

---

637 The medium-long term based on debt reduction could be based on a very efficient and proper economic analysis which could evaluate the distance and adjustments needed between the present debt level and the target, fiscal sustainability by considering whether the country adopts specific reforms for improving growth and finally, a general annual analysis of the economic situation based on the updated debt levels. Debt reduction would be based on *ad hoc*-country-focused analysis based on its internal structure. Z. Darvas, P. Martin, X. Ragot, The economic case for an expenditure rule in Europe, http://bruegel.org/2018/09/the-economic-case-for-an-expenditure-rule-in-europe/ , published on the 13th September 2018, consulted on the 20th November 2018.

638 With a new set of rules for national adjustment accounts, a member state would be permitted to exclude some spending from the measurement of the government deficit (incremental unemployment expenditure and incremental public investment spending). By excluding some spending, it could provide temporary stimulation to the economy, while providing a better protection for workers and therefore a powerful instrument for macro-economic stabilisation. A. Bénassy-Quéré, X. Ragot, W. Guntram, ‘’Which fiscal union for the Euro-area?’’, cit., p. 10

639 An expenditure rule might generate countercyclical effects in case of unexpected demand. Indeed, nominal growth of expenditures is not influenced by a shock while a negative demand shock might generate inflation below the expectations. Being nominal expenditures based on the expected inflation, a negative demand shock might have a positive fiscal stimulus as it could generate a higher real growth rate of public expenditures. Similarly, in case of negative supply shock, the expenditure rule might generate a deficit while the expected inflation might reduce stabilization. C. Teulings, The EU’s fiscal rules urgently need a revision, https://voxeu.org/article/eu-s-fiscal-rules-urgently-need-revision?utm_source=GDPR&utm_campaign=e693d7b482-EMAIL_CAMPAIGN_2018_09_14_09_34&utm_medium=email&utm_term=0_7c51e322b7-e693d7b482-278644353, published on the 13th September 2018, consulted on the 20th November 2018.

weak enforcement. Large sanctions, indeed, simply worsen the economic and financial situation of an already distressed country limiting both credibility and appropriateness of the enforcement rules[640].

A more credible and efficient compliance system based on transparency, simplicity and binding rules should be set up through surveillance, market discipline and political credibility. For example, benefits from Euro membership could be put on a conditional line if non-compliance with fiscal rules occurs[641]. A change in the current ineffective and damaging enforcement should occur. For instance, a form of fiscal rewards for a country might be given whenever it respects fiscal rules. Similarly, in case of non-compliance, political costs should be increased as political consequences would have a major impact than a sanction-mechanism and would result in more political accountability, for example by appearing before the European Parliament. Market discipline is absolutely requested due to imprudent fiscal policies adopted in the past. Yet, compliance should be foster through incentives for fiscal prudence rather than fiscal penalties[642]. Hence, only in very exceptional cases, for instance, in case of natural disasters and economic downturn, an escape clause could enter into force to allow temporally deviations from the rule[643].

Being the European fiscal framework clarified by the TFEU, the SGP and the other provisions adopted (Fiscal Compact, Two Pack, Six Pack), little changes in the legal framework might be needed for introducing *the new expenditure rule*. Yet, problems might occur due to an almost impossible ratification process to change or dismantle the intricate and complex structure.

Nonetheless, in accordance with art. 126 TFEU, the new expenditure rule would conform more or less the indicators provided as *the expenditure rule* would aim at reducing public debt, even though it might slightly exceed the 3% deficit rule[644]. Still according to art. 126 TFEU, the European Council has the right to decide «without undue delay» the effective period within which a country need to comply with the deficit, «bringing that situation to an end within a given period». Hence, the procedure would be legally possible within the current framework[645].

---

640 Enforcement rules are expected to have a credible return by moving a country toward a more appropriate and sustainable fiscal position with lower sovereign spread. Nonetheless, the SGP and especially, the Excessive Deficit Procedure (EDP) reveals another reality. When a country violates the 3% deficit rules, sovereign spreads tend to be much higher – by 50 or 150 points more - as markets expect a weaker commitment to fiscal discipline. X. Debrun, L. Eyraud, A. Hodge, V. Lledo, C. Pattillo, ‘’Second-generations fiscal rules: From stupid to too smart’’, cit.

641 Z. Darvas, P. Martin, X. Ragot, ‘’The economic case for an expenditure rule in Europe’’, cit.

642 Z. Darvas, P. Martin, X. Ragot, ‘’European fiscal rules require a major overhaul’’, cit., pp. 15-16.

643 Reducing the current number of escape clause and exceptions would be the first step for simplifying the current complex and non-transparent Eurozone framework. Since these provisions have been mainly introduced through European Regulations and Guidelines laid down by the European Commission and the Council, they could be abolished without the need of applying changes in the Treaty (as they are not enshrined in the Treaties or intergovernmental agreements). L. Feld, C. Schmidt, I. Schnaebel, V. Wieland, Refocusing the European fiscal framework, cit.

644 See. Art. 126(7) TFEU.

645 Z. Darvas, P. Martin, X. Ragot, ‘’European fiscal rules require a major overhaul’’, cit., p.17.

All attempts to centralize and coordinate fiscal rules in the Eurozone have always failed and rather produced a generalize discontent. Yet, at European wide-aggregate level, the fiscal stance cannot be ensured through a fully decentralized solution. Both positive and negative spill-overs in one European country should be considered as they negatively or positively impact another Eurozone country resulting in a suboptimal fiscal stance of the whole Eurozone.

The failure of fiscal coordination, probably also due to the exemption clauses, demonstrates inefficiency in ensuring stabilisation in the Euro-area[646]. An appropriate fiscal stabilization should be introduced to provide the right equilibrium among countries and fiscal stance needed for enhancing the right impulses and right incentive towards fiscal discipline while reducing divergences among the Eurozone countries . Some improvements in terms of fiscal stance and discipline should occur. Firstly, fiscal rules would be supported by an efficient tool and secondly, risk-sharing among Eurozone would increase by limiting both asymmetric shocks and debt increase[647].

By complementing fiscal and private risk-sharing with Banking Union and Capital Market Union, also public risk-sharing would increase. Eurozone architecture and framework might thus evolve into a more solid and stable one being economic and fiscal resilience strengthened. Surely, small political steps must be taken to make some progress in the Euro-area fiscal stance and ensure a more efficient risk-sharing, even though they might encounter hostility. Yet, implementing trust is a requirement for delivering better results.

3.3.2. Resocialising Eurozone: The European Unemployment Insurance Scheme (EUIS)

To ensure a well-functioning single currency area, certain specific conditions shall be met and, surely, some corrective mechanisms adopted. Most problems affecting Eurozone are its size with different structural economic conditions and the absence of efficient mechanisms for coping with economic divergences and asymmetric shocks, resulting in large imbalances (external deficits and surpluses), high unemployment and slow growth. A well-functioning monetary union requires institutional setting, labour mobility and market flexibility.

Eurozone needs a mechanism to improve and provide stabilization in time of crisis and recessions. Eurozone countries tend, indeed, to rely excessively on monetary policy as the primary tool for stabilizing cyclical shocks. Yet, the ECB is not only moving in a scenario constrained by the zero-

[646] General exemption clauses under the *preventive* and *corrective arms* are introduced in several fiscal treaties and procedures. However, they should not be implemented as the disrespect and non-achievement of Eurozone fiscal discipline might be a direct consequence and cause of this excessive flexibility. As a result, more automaticity should be ensured in all surveillance macroeconomic procedures, with no exception. If members states failed to comply with the recommendations provided, there should be consequences. N. Baltas, Strengthening the Economic Governance of the Euro Area, Athens university of economics and business, *working paper series*, XX (2013), p. 7-8.

[647] G. Claeys, ‘’The missing pieces of the Euro architecture’’, cit., pp. 12-17.

lower-bound (ZLB) on interest rates but monetary policy is not even supported by efficient fiscal policies[648].

Some scholars and economist suggest that solutions should come through the creation of a full-fiscal union. Yet, besides being an excessively ambitious project, lack of support and clear opposition among European countries are quite evident. On the contrary, the establishment of a fair system of insurance with the aim of spreading solidarity among Euro-countries and providing benefits in the long-run while alleviating strains and pressures in bad times exerted by Stability and Growth Pact, might be backed up[649].

Post-Great Recession, return to prosperity, economic recovery and growth has been extremely low (0.2% in 2018) while unemployment has exploded (amounting up to 8.1% in October 2018 in the Eurozone with an average of 9.7% between 1995 and 2018)[650]. Moreover, the assumption that austerity would have brought benefits did not work and rather has brought collateral effects.

Promoting growth and full employment shall be a priority. Hence, it is necessary to create stabilizers for Eurozone economies and governments facing financial shocks and crisis.

Being the Eurozone affected by a very low labour mobility, enhancing internal and intra-Eurozone migration might not be the right solution for adjusting asymmetries and divergences affecting the countries, as the Optimum Currency Area Theory suggests[651]. One the one hand, worker mobility has been less than optimal in the Eurozone; on the other, mass migration rather than improving the cohesiveness among the European countries might raise a collateral effect: political friction and hostility. Eurozone is composed of different languages, cultures and history that simply create cultural and linguistic barriers preventing citizens from moving from one Eurozone country to another.

As the sovereign debt crisis demonstrated, capital investments from Core to Periphery could endanger the stability of Eurozone, even though nowadays further mechanisms, such as Banking Supervision, have been adopted. Likewise, structural reforms introduced under austerity, in several countries, such as Greece and even Cyprus, did not work. Rather than improving internal market and economic

---

648 G. Tabellini, ''Building common fiscal policy in the Eurozone'', in R. Baldwin, F. Giavazzi (edited by) *How to fix Europe's monetary union: views of leading economist*, London, CEPR Press, (2016), p. 120.

649 S. Dullien, J. Fernández, M. López, G. Maass, D. del Prado, J. von Weizsäcker, ''Fit for purpose: a German-Spanish proposal for a robust European Unemployment Insurance'', *working paper*, Bonn, Friedrich Ebert Stiftung, (2017), p. 3.

650 Trading economics, Euro Area Economic Indicators, https://tradingeconomics.com/euro-area/indicators, consulted on the 19th December 2018.

651 According to the Optimum Currency Area (OCA), if labour and flexibility are insufficiently mobile within a monetary union, then the currency is not expected to perform a stabilization function attributed to it and rather, it could bring to higher unemployment and inflation. Moreover, according to Mundell, if regions are affected by factor immobility (like in the Euro-area), then they should actually have separate currencies and flexible exchange rates. R. Mundell, ''A Theory of Optimum Currency Areas'', cit., pp. 662-664.

conditions, internal devaluations and free-trade market policies further endangered national economies worsening recession in terms of growth, unemployment, social effect and instabilities[652].

The sovereign debt crisis showed that both capital flows and internal depreciations are neither a suitable approach to be applied in all the Eurozone countries for overcoming any asymmetric and divergent shock nor an appropriate substitute for flexible exchange rate. Both can have a destabilizing effect[653].

Structural reforms were supposed to improve market and labour flexibility and reduce the cost of shocks. Yet, even though they are economically desirable, they are not socially viable as they imply social cuts, lower minimum wages and increasing unemployment. Hence, rather than enhancing support in favour of the Euro and Eurozone, they can encourage the idea of leaving it[654].

As a matter of fact, the only credible mechanism that remains is fiscal transfer, even though art.125 TFEU might prevent a similar mechanism. This shall be accompanied by further fiscal discipline and closer fiscal supervision for both avoiding risks and rebooting Eurozone.

Even though Macroeconomic Imbalances Procedure (MIP), the Single Supervisory Mechanism (SSM). and the European Stability Mechanism (ESM) have been introduced, with the latter used for very extreme situations and extended also to non-euro member states, the EMU still lacks an automatic stabilizer. Yet, it should for several reasons: (1) it should not lead to permanent transfers; (2) it should create incentives for sound policies and for coping with weak policies; (3) it should be established within the current framework without incurring into legal amendments and (4) it should prevent crisis and avoid intervention of the ESM[655].

---

652 As the sovereign debt crisis demonstrated, the Periphery countries suffered from a sudden stop of capital flows, which resulted in a collapse of both domestic consumption and investments and increasing deficit and debt. The idea of introducing capital controls is simply impossible within a monetary union and would seriously compromise the credibility of a similar institution. Similarly, internal devaluation and depreciation, initially highly praised by the Troika, did not work in Greece and rather, had a reversal effect. On the one hand, both labour costs and real rates have fallen as well as prices (thus increasing competitiveness thank to a rise in exports and a fall in imports); on the other, also domestic demand has collapsed drastically endangering recession. Investments dropped due cut-spending and tax-increases while unemployment exploded accompanied by malfunctioning banks. C. Pissarides, ‘’Rebooting Europe: Closer Fiscal cooperation needed’’ in R. Baldwin and F. Giavazzi (edited by) *How to fix Europe’s monetary union,* London, CEPR Press, (2016), pp. 134-135.

653 The double-dip recession that impacted Europe has been wrongly managed due to the imposition of restrictive fiscal policies and fiscal consolidation, accompanied by wrong macroeconomic adjustments. On the one hand, debtor countries, i.e. Spain, Greece and France, were badly hit by austerity policies while creditors, i.e. Germany and France, continued pursuing restrictive policies, with the aim of balancing their budget while they should have pursued expansionary policies for equilibrating the scenario. E. Marelli, M. Signorelli, ‘’Convergence, Crisis and unemployment in Europe: the need for innovative policies’’, cit., pp. 32-33.

654 P. De Grauwe, Y. Ji, ‘’How to reboot the Eurozone and ensure its long-term survival’’, in R. Baldwin and F. Giavazzi (edited by) *How to fix Europe’s monetary union,* London, CEPR Press, (2016), cit. pp. 138-141.

655 M. Beblavý and K. Lenaerts, ‘’Stabilising the European Economic and Monetary Union: What to expect from a common unemployment benefits scheme’’, *CEPS Research Report*, II (2017), p. 2.

A fiscal capacity is a tool that is absolutely required to stabilize Euro-economies whenever they are hit by an asymmetric shock and the monetary policy is unable to contain the impact of a shock while making fiscal policy more countercyclical. Fiscal capacity could be provided through a European Unemployment Insurance Scheme (EUIS), with the aim of stabilizing the aggregate demand in a country where unemployment increases due to an adverse economic shock, by paying funds coming from the European Unemployment Insurance Fund to the unemployed or through transfer injected into national unemployment insurances, (having a re-insurance effect).

As long as sovereign debts remain high, governments will be somehow forced towards pro-cyclical fiscal consolidation in times of economic recession. An automatic fiscal stabilizer for the whole monetary union is needed to contain short-term cyclical downturns and compensate for structural differences while responding directly to asymmetric shocks or pressures in the monetary union.

The main point of automatic stabilizers is to keep enough spending in downturn. It is very important to minimize both economic and social damages and strengthen European fragility. Hence, fiscal transfers could be granted for solving asymmetric and cyclical shocks where hypothetically speaking, all member states will become contributors or beneficiaries in the long-term[656]. Reducing fluctuations on the economic cycles among Eurozone countries must be a priority.

The hypothetical European Unemployment Insurance Scheme (EUIS) could be activated in time of exceptional and dramatic conditions, such as crisis or large and negative shocks where a country suffers from an increasing short-term unemployment rate. An insurance mechanism might have a two-fold scope: (1) smoothing fluctuations and (2) helping develop a solid fiscal stance at Eurozone level by containing negative spill-overs, especially in time of crisis. Hence, besides creating room for cyclical stabilization both at a country level and euro-level, the scheme would alleviate the impact of economic shocks[657].

In other words, the creation of a similar insurance would beneficial in the medium-term also to those countries who do not directly benefit from it. Basically, it would provide a more stable macroeconomic environment and better perspectives over growth at EMU level[658].

EUIS could work as a temporary fiscal transfer-system and as fiscal-resources-support for complementing Eurozone national economies, where the country undergoing an economic boom would transfer resources for a limited period of time, such as one year, to the country in recession experiencing an increasing unemployment rate levels.

Creating a common unemployment support would be extremely beneficial to Eurozone-labour-market as it would basically amplify positive spill-overs among countries. Since adjustments through

[656] L. Andor, ‘’Basic European Unemployment Insurance – The best way forward in strengthening the EMU’s resilience and Europe’s Recovery’’, *Intereconomics*, XLIX, IV (2014), pp. 187.

[657] S. Dullien, J. Fernández, M. López, G. Maass, D. del Prado, J, von Weizsäcker, ‘’Fit for purpose: a German-Spanish proposal for a robust European Unemployment Insurance’’, cit. pp. 5-6.

[658] Ministro dell’Economia e delle Finanze, ‘’European Unemployment Insurance Scheme’’, *working paper*, X (2015), p. 2.

exchange rate cannot occur anymore, EUIS might be the right response for addressing employment cycles and dynamics emerging as a first step towards the creation of a Eurozone-stabilization-instrument by solving asymmetric shocks and consolidating social solidarity among Eurozone members and citizens[659].

EUIS might be distinguished in two different types of insurance schemes: (1) *equivalent*, which would be characterized by a financial transfer of a lump sum (calculated considering deviations of short-term unemployment from the usual average of the country and defined by eligibility criteria) from the hypothetical European Insurance Fund to national budgets and where the scheme aims at macroeconomic stabilization to contain effects of an economic crisis and (2) *genuine*, which aims at limiting social risk by paying financial support directly to individuals affected by unemployment without the need of fulfilling eligibility criteria. *Genuine schemes* would aim at strengthening social cohesion while limiting the impact of social risks of the unemployed[660].

Assistance coverage should be limited to short-term unemployed and not to long-term one, which might be a cause of structural problems in national labour market. A similar scheme might be financed through a single contribution rate paid by all workers, independently of the economic situation[661].

Hypothetically speaking, the mechanism might be financed through resources (for example through contributions of employers and employee or countries) to be pooled into a fund, hypothetically the European Unemployment Insurance Fund that could be administered and coordinated by the Commission or a new *ad hoc* body. In normal times, Euro area countries might pay a contribution of their of GDP to the Fund, where this could be divided into *a national compartment* set up for the country and working as a self-insurance and *a re-insurance compartment* for large shocks[662].

---

[659] Already in 2012, the European Commission made a proposal in the Communication on the Social Dimension of EMU on the creation of an insurance system stressing that «a common instrument for macroeconomic stabilisation could provide an insurance system to pool the risks of economic shocks across Member States, thereby reducing the fluctuations in national incomes. [...]. A stabilisation scheme to absorb asymmetric shocks could require monetary net payments that are negative in good times and positive in bad times». European Commission, ‘’Final communication from the Commission to the European Parliament and the Council strengthening the social dimension of the Economic and Monetary Union’’, COM(2013) 690, [2013], p. 11.

[660] R. Repasi, ‘’Legal Options and Limits for the Establishment of a European Unemployment Benefit Scheme’’, *CEPS research project,*, I (2017), pp. 8-9.

[661] The revenues for the establishment of a Unemployment Insurance Scheme could come directly from contributions paid by both employers and employees. A similar mechanism might require an harmonization of the current labour market. Another feasible solution is the application of different contribution rates in different Eurozone members considering the functioning and the efficiency of the labour market implying that contributions will be higher in less efficient countries, even though it might endanger the stabilisation purpose. Another option is establish contribution by introducing a country-targeted contribution rate that can be adjusted yearly or an on-going basis. G. Clayes, Z. Darvas, G. Wolff, ‘’Benefits and drawbacks of European Unemployment Insurance’’, *Bruegel Policy Brief,* VI (2014), pp. 4-8.

[662] The mechanism could work in such a way that if a member state experiences a rise in unemployment, for instance by 0.2%, it could receive a net contribution from the *national compartment* for supporting the increase in unemployment. On the contrary, if a country suffers from a very large economic shock (more than 2%), than, it would receive additional contribution from the *re-insurance fund* where pay-outs and transfer

Once the fund is set up, member states might pay a contribution in good times (when their economies perform well) while receiving a net pay-out in case of recession or economic shocks[663]. EUIS would basically pay benefits directly to unemployed individuals with fund-contributions paid both by employers and employees. Contribution and transfers should be sent from one country to another, whenever short-term unemployment increases and exceeds threshold considered[664].

The limited duration of fiscal transfer (given to countries to support the impact and costs of short-term unemployment) would transform the European Unemployment Insurance Scheme into a very safe option.

Without doubt, transfer should be made quickly so as countries could work with funds available and prevent any further pro-cyclical effect while fostering the counter-cyclical. Indeed, each country would be allowed to run a deficit up to 2% - it being financed through loans from national compartment and Unemployment Fund, if resources and funds are exhausted.

Hence, it would provide benefits to those Eurozone unemployed countries where the net transfers could be based on changes in the unemployment rates in the short-term and the resources given should be used for stabilization purposes and supporting the national system. In other words, the net transfer or payment would be proportionate to unemployment rates[665].

EUIS would work with the aim of favouring long-run convergence, even though other programs were already launched at the European level but did not bring the expected results[666].

---

are proportional to the increase in unemployment. Basically, by providing this extra-contribution, a Euro-country could loosen its fiscal constraint. The scheme would provide a much more credible fiscal stabilisation to contrast shock by allowing also to run deficit while promoting a stabilizing effect. S. Dullien and D. Perez del Prado, for instance, propose an *ad hoc* way for financing the EUIS: «Under such a scheme, each country would pay in 0.1 percent of its GDP each year into a common European unemployment fund or budget line. 80 percent of the country's pay-ins would be earmarked in a national compartment, the other 20 percent would go into a common compartment for very large shocks (a "stormy day fund")». S. Dullien, J. Fernández, M. López, G. Maass, D. del Prado, J, von Weizsäcker, ''Fit for purpose: a German-Spanish proposal for a robust European Unemployment Insurance'', cit., p. 7.

[663] M. Beblavý, K. Lenaerts, ''Stabilising the European Economic and Monetary Union: What to expect from a common unemployment benefits scheme?'', cit., p. 3.

[664] An advantage of basing EMU fiscal shock absorber on short-term unemployment is related to the fact that this indicator follows and considers all developments in the economic cycle – it being easily measurable and understandable. The scheme should focus on cyclical unemployment caused by a fall in aggregate demand. Payments from the hypothetical Insurance Fund would be activated whenever the short-term unemployment rate (covering for instance an unemployment period of 0 to 12 months) of a specific country at a specific time exceeds the threshold, which is calculated considering the sum of 10 years moving *on average* of the short-term unemployment rate in a specific country. L. Andor, ''Basic European Unemployment Insurance – The best way forward in strengthening the EMU's resilience and Europe's Recovery'', cit., p. 187.

[665] G. Thirion, ''European Fiscal Union: Economic Rationale and Design Challenges'', cit., pp. 19-21.

[666] In March 2000, the EU heads of state and government launched the Lisbon Strategy with the aim of making Europe «the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion» by 2010 by basing the program on both economic and social pillars. In 2005, Lisbon strategy was renewed by readdressing it on growth and job with integrated guidelines (provided by Spring European Council) over microeconomic, macroeconomic and employment level. Within this framework, four main priorities were established: (1) Investing more in

An Unemployment Insurance Mechanism would be desirable for three important reasons: (1) it would work as an important automatic stabilizer function absorbing the impact of recession and smoothing unemployment; (2) it would be a very effective tool in terms of social policy and solidarity among Eurozone workers since it would play an important social insurance and (3) badly affected countries would be further supported by fiscal resources[667].

Since EUIS would imply a transfer of money distributed over a certain period of time, a sort of reimbursement through revenues post-shock might be set up (for instance, by introducing contribution rates on wages or corporate taxes)[668].

The European Unemployment Insurance Scheme could be adopted as a mechanism for reducing volatilities and economic dispersion over time by allowing to accumulate both deficits and surpluses while increasing risk-sharing. The EUIS would work in favour of a balanced budget by ensuring incentives towards fiscal discipline and making possible the adoption of countercyclical fiscal policy, as it would work as an automatic mechanism[669].

With its automatic and countercyclical effect, the EUIS might spread confidence and trust in market, while reducing the impact and reoccurrence of austerity, downgrades and also internal devaluation. On the contrary, it would support both domestic demand and economic growth in all European countries as EUIS would provide a fiscal leeway to European countries. Moreover, the creation of the EUIS would solidify the monetary union by creating a common stabilizer thus reducing uncertainty among countries in the short and long-term. Social cohesion in the EMU would be thus fortified from an institutional and political point of view[670].

Nonetheless, even though a EUIS system is politically attractive, great difficulties and disincentives for further progress should not be underestimated. Stabilization effects might be few and

---

knowledge and innovation; (2) Unlocking business potential, especially for SMEs; (3) Increasing employment opportunities for priority categories and (4) Climate change and energy policy for Europe. Already by 2004, a report on the Lisbon strategy concluded that even if some progress was done, most of the goals were not achieved. This failure was further stressed by the former Swedish Prime Minister, Fredrik Reinfeldt, that concluded that the progress was made but was still not sufficient. Indeed, most of the goals were not achieved. As a result, this strategy has been succeeded by Europe 2020, which is a 10–year strategy for fostering progress in the European economy through a smart, sustainable and inclusive growth focused on (1) Employment; (2) Research and development (R&D); (3) Climate change and energy, (4) Education and (5) Poverty and social exclusion. Eurostat is the body entitled to monitor progress and national implementation of the goals to be achieved by 2020.

667 G. Thirion, ‘’European Fiscal Union: Economic rationale and design challenges’’, cit., p. 20.

668 In order to ensure an appropriate stabilizing fiscal rules, it would be better not to provide permanent fiscal transfer to country badly and hardly hit. Rather, they should be established in such a way that the give the right incentives and stimulus to reform and conform with the fiscal rules. Claeys, ‘’The missing pieces of the Euro architecture’’, cit., pp. 18-21.

669 The EUIS could work as an additional instrument for those countries running out of fiscal space. It could work as ‘’a shelter’’ by avoiding cuts in the automatic stabilizers, limiting pro-cyclical cuts and even allowing discretionary fiscal policy. G. Clayes, Z. Darvas, G. Wolff, ‘’Benefits and drawbacks of European Unemployment Insurance’’, *Bruegel Policy Brief*, VI (2014), p. 4.

670 L. Andor, ‘’Basic European Unemployment Insurance – The best way forward in strengthening the EMU’s resilience and Europe’s Recovery’’, cit., p. 185.

heterogeneous, especially for those countries, such as Italy, that are affected by long-term unemployment and rigid labour markets[671].

An harmonization of Eurozone labour market institutions, through the adoption of structural reforms on an *ex-ante* conditionality and a better coordination of policies to ensure an alignment of price and wage developments might be required to limit moral hazard and permanent transfer and provide the same eligibility requirements, even though still some differences might persist and political opposition might occur for changes in social standards[672]. Undoubtedly, wage-setting system and heterogeneities in the European labour system are the primary factors causing divergences in terms of labour costs. However, reducing unemployment while ensuring social protection is absolutely necessary within the Eurozone since social and political consequences are becoming dramatic, especially for the young people, who should have received an appropriate toolkit under the ineffective ''Youth Guarantee Recommendation'', launched in 2013[673].

In order to avoid institutional moral hazard and prevent lasting and permanent fiscal transfers, corrective measures in terms of claw-back provisions, risk-based adjustment mechanisms and also experience-rating mechanism could be introduced[674].

---

[671] G. Claeys, ''How to build a resilient monetary union? Lessons from the Euro Crisis'', cit., pp. 29-32.

[672] Labour markets within Eurozone are differently organised being a direct result of history, different preferences and social policies. Eurozone countries differ in terms of employment protection and legislation, training schemes and employment services, wage-setting system, the degree of involvement of social partners and also corporate governance. Unemployment rate in the different EU countries reacts differently to the same shock. Harmonising labour markets in the Euro area might be hypothetically needed for ensuring a well-functioning EMU and fostering labour mobility. Yet, since a reform and harmonization of labour market could undermine preferences of the countries, it could not be justified only by the introduction of the EUIS. G. Clayes, Z. Darvas, G. Wolff, ''Benefits and drawbacks of European Unemployment Insurance'', cit., p. 5-8.

[673] Following the Council Recommendation of 22nd April 2013 (2013/c 120/01), a Youth Guaranteed was adopted to response to high levels of youth unemployment in Europe. This Council Recommendation is a serious commitment by Member States to ensure (as clarified in art. 5) a good offer of internship, apprenticeship, training, education or employment within four months of becoming unemployed or leaving education. Even though it stands as one of the most innovative labour market policies and has received social support, it is still doubtful whether it is actually contributing to decreasing youth unemployment as an empirical evaluation is not conducted systematically.

[674] A *risk-based adjustment mechanism* could be introduced in the EUIS. Under this rule, countries accumulating deficit (over 0.5% for instance) in their national compartments could be asked to pay higher contributions as soon as they stabilize unemployment and the latter, gradually decreases. Higher contribution payments could be designed in a progressive way where larger contributions would be made if unemployment decreases quickly provided that a formula and mechanism are inserted in such a way that they prevent excessive and abrupt increase. *Claw-back provisions* would be useful as they would collect additional contributions from those countries building deficits. Basically, clawbacks neutralise net transfer *ex post*, suggesting that member states might turn into net beneficiaries for several years but in the end, their contributions are adapted to compensate for the net transfers that they received. *Clawback* mechanism would adjust automatically contribution rates to European system in one single country whenever it is found to be a contributor or a payer over an extended period of time. They would aim at limiting problems (deriving from the fact that they take money in countries affected by recession thus risking to limit the stabilization effect) and moral hazard since they would ensure stabilization. A similar mechanism provides a financially stable stabilization mechanisms to those countries hit by severe economic shocks. Finally, *experience rating* is a

Before equipping Euro-area with an effective and efficient fiscal transfer, further study might be needed before proposing a legislative act. More research should be conducted on how to coordinate and set minimum standards to reintroduce the short-term unemployed into labour market. Yet, introducing a European Unemployment Insurance Scheme might increase incentives for creating a much more flexible labour market and protecting unemployed people as some short-term costs deriving from structural reforms in labour market would be covered at European level, even though convergence with regards to labour market policies and institutional capacity might be needed. EUIS could thus strengthen social dimension and cohesion while reducing poverty and inequalities within EMU thus complying with the *European Pillar of Social Rights*[675]. It is fundamental to create the possibilities of macroeconomic adjustment within the Eurozone where both aggregate demand and economic growth can be kept.

Structural reforms and austerity cannot be the solution and response to cyclical developments. On the contrary, an automatic stabiliser at the EMU level would basically help supporting demand at the right time while preventing short-term crisis from creating a long-term divergence within the monetary union. In this way, EUIS would not stand as more intrusive approach from European rules into national-making policy but rather, it would emerge as a mechanism to fortify the autonomy of every Euro-country by stabilizing EMU[676].

EUIS would contribute to macroeconomic stabilization within the participating countries where the net amount of contribution of a country would fall in case of economic downturn, while pay-outs would increase in case of rising unemployment. However, estimating the stabilization impact for the euro-area might be very difficult as there is no data available on which share of the unemployed would actually receive benefits under EUIS. Data over short-term unemployment are available as they are published by Eurostat. On the contrary, simulating the pay-outs from the system with an exact precision might be a great problem as it would require data on employment and history, which are not

---

mechanism that basically links pay-in into the EUIS to its effective use by states, asking higher contribution from those countries that are expected to use it more than other. Under the *experience rating*, the contributor is basically monitored and its contributions are adjusted at the beginning of every period so that member state is brought closer to a projected balance in line with the scheme (over the medium term). *Experience rating* is seen as a financial incentive for member states for reforming labour markets and prevent permanent fiscal transfers. Even these mechanism might have an impact over the macroeconomic stabilization (by ensuring a country-level neutrality), they might be necessary for increasing political acceptance, especially for those countries that might turn into net payers. M. Beblavý, K. Lenaerts, ‘’Stabilising the European Economic and Monetary Union: What to expect from a common unemployment benefits scheme?’’, cit., p. 10; L. Andor, ‘’Basic European Unemployment Insurance – The best way forward in strengthening the EMU’s resilience and Europe’s Recovery’’, cit., pp. 188

[675] M. Beblavý, K. Lenaerts, ‘’Stabilising the European Economic and Monetary Union: What to expect from a common unemployment benefits scheme?’’, cit., p. 10.

[676] L. Andor, ‘’Basic European Unemployment Insurance – The best way forward in strengthening the EMU’s resilience and Europe’s Recovery’’, cit., p. 189.

available. As a matter of fact, without these data, only roughly approximation of both the number of unemployed covered by EUIS and overall benefits can be made[677].

Undoubtedly, a similar project consists of a long-term vision that might influence not only market expectations on more prosperity and stability but it could also have a direct impact on the economy while promoting adjustments. Likewise, it could stimulate convergence of different labour markets and institutions by means of appropriate national incentives and series of reforms for improving the functioning of the Euro-area.

Heterogeneities still exist suggesting that something more has to be done to overcome the current unsatisfactory condition. Divergences Euro-countries (Core and Periphery) represent a realm threat to the existence and survival of the single currency and risk undermining also the stability of the EU. Therefore, it is absolutely needed to strengthen not only the architecture of the EMU but also the social dimension to the extent that a mechanism of solidarity should be established with the primary aim of injecting confidence and trust in the benefits deriving from the monetary union.

EMU needs to become more resilient against financial and economic shocks by establishing mechanism within the objectives of the Treaties for ensuring economic growth, full employment and social progress. The creation of a European safety net should be sufficient to support the recovery of European economies, where these would share costs and benefits of short-term unemployment insurance. A similar scheme would basically provide a short-term fiscal stimulus to economies undergoing a downturn or economic recession[678].

A mixture of active policies at both national and European level should be accompanied with the establishment of a mechanism for monitoring Euro-area countries competitiveness and preventing further divergences and heterogeneities.[679]. A common European approach for solving cyclical and

---

677 S. Dullien, ‘’The Macroeconomic stabilisation impact of a European basic unemployment insurance scheme’’, cit., p. 191.

678 Social cohesion should be absolutely strengthened as the second recession in Europe (2011-2013) was caused by an incomplete EMU. In 2008-09, European countries agreed to launch coordinated economic stimulus, under the European Economic Recovery Plan**,** amounting up to 200 billion euro and 1.5% of GDP and allowing also to increase national deficits. This Plan helped recovering from the first recession by paying unemployed people, keeping investments and avoiding tax increases. Yet, it was not sufficient for overcoming the second recession (sovereign debt crisis). Indeed, rather than containing the crisis, other interventions in Spain and Ireland were needed confirming also the EMU instability. The Eurozone became a ‘*’club’’* of debtors and creditors while the Euro a real trap. Countries were prevented from adjusting to economic shocks through *ad hoc* tailor-made policies (monetary and fiscal) and also exchange-rate devaluations. Inevitably, countries suffered from problems in their balance of payments and were obliged to opt for internal devaluations and accept bailout loans that seriously impacted social conditions and employment. L. Andor, ‘’Basic European Unemployment Insurance – The best way forward in strengthening the EMU’s resilience and Europe’s Recovery’’, *Intereconomics*, XLIX, IV (2014), pp. 184-185.

679 Andrea Sapir suggests the creation of a Euro-system Competitiveness Council (ECC) whose primary aim would be the coordination of actions and decisions over wages that should be established as a fixed norm in order to prevent competitiveness problems. A. Sapir, G. Wolff, ‘’Euro-Area Governance: What to reform and how to do it’’, cit., pp. 5-6.

large shocks shall be found collectively. National stabilization mechanism risks amplifying instabilities in the monetary union.

3.3.2.1. Creating the right legal framework for EUIS

Fixing the Eurozone is one of the main challenges faced by European leaders, requiring steps to ensure responsibility, solidarity and a more solid Euro-architecture. Therefore, the design of the European Unemployment Insurance Scheme should be as simple as possible and above all, it should promote a gradual transformation in the Governance of the EMU so as to address asymmetric shocks.

Enormous differences persist among the different Eurozone countries. Hence, smoothing heterogeneities should be a top priority for creating an efficient labour mobility and labour market, reducing both moral hazard and avoiding permanent transfer. A mechanism for absorbing sufficiently asymmetric shocks might be created, even though designing fair and well-working unemployment insurance scheme might require a substantial harmonization of both labour market and welfare system[680].

The mechanism could help solve or, at least, readdress short-term cyclical unemployment. Yet, a prompt and effective action should be taken through active labour policies to contain structural unemployment. EUIS might be used only in exceptional cases, when unemployment rate increases and a country suffers from negative and large shocks. To settle the problem and limit pro-cyclical cuts, benefits and costs should be contained in time and size. Hence, assistance and access to the scheme would be granted provided that harmonized conditions of labour are activated.

EUIS might be the right approach for overcoming asymmetric shocks. Yet, the real challenge lies in the creation of an appropriate and sound legal basis to empower European institutions within the mandate of the current Treaties; for instance, by anchoring it to the existing primary and secondary EU legislation without committing a breach. Even though there are enormous advantages for designing a similar mechanism, technical and legal complications exist. Indeed, two sections stand as the most troubling: (1) payment side of the scheme and (2) financing issues.

More in detail, art. 136 TFEU (in line with art. 121(2) TFEU which defines multilateral surveillance and economic coordination) and art. 175(3) TFEU might provide the basis[681].

---

[680] Art. 114(1) TFEU clarifies competences in market harmonisation for ensuring the establishment and functioning of the internal market. In addition to, the European Court of Justice has stressed in several sentences that under art. 114(1) TFEU, legal provision acts that fall in another field than internal market can be adopted «provided that the conditions for recourse to Article 95 EC [corresponding to new art. 114 TFEU] as a legal basis are fulfilled, the Community legislature cannot be prevented from relying on that legal basis on the ground». European Court of Justice, *British American Tobacco (Investments) and Imperial Tobacco*, C-491/01, [2002], par. 62. Therefore, under this article, the Union legislator might adopt a legal act or provision for contributing to the process of harmonisation.

[681] Art. 121 TFEU (in conjunction with art. 136 TFEU) was used to provide the legal basis for launching the Two Pack Regulation for ensuring more restrictive rules over economic policy coordination among Euro-countries and adopting sanctions in case of non-compliance. Art. 121 TFEU (*multilateral surveillance*) aims at ensuring a «closer coordination of economic policies and sustained convergence of the economic

Under art. 136 TFEU, the Council is entitled to «adopt measures specific to those Member States whose currency is the euro» to strengthen economic coordination, given that the scope of art. 136 TFEU is directly linked to multilateral surveillance procedure. Under this article, EUIS would be established with the primary aim of ensuring economic coordination in an attempt to contain and smooth negative spill-overs resulting from asymmetric shocks for ensuring economic convergence, prosperity and benefits deriving from the single currency.

Considering art. 175(1) TFEU, the legal framework devotes to provision of funds for social cohesion by «support[ing] the achievement of these objectives [those set out in art. 174 TFEU - strengthening of its economic, social and territorial cohesion] by the action it takes through the Structural Funds»[682]. Under art.175(3) TFEU specific actions might be adopted, if necessary, «outside the Funds and without prejudice to the measures decided upon within the framework of the other Union policies»[683]. EUIS would come indeed as a specific action for spreading benefits to a consistent part of the European Union (the Eurozone) to respect and pursue also objectives established upon art. 174(1): «an overall harmonious development» and «the strengthening of its economic, social and territorial cohesion»[684]. In a similar legal context, «specific actions» might provide an appropriate legal

---

performances of the Member States». Therefore, economic developments are to be monitored to fulfill the objectives: (1) «consistency of economic policies with broad guidelines» and (2) «the proper functioning of economic and monetary union».

682 Two obstacles might hinder art. 174 TFEU: (1) one problem emerges whether *social cohesion* could be considered a single and only objective or shall be read exclusively together with economic and territorial cohesion where social cohesion might strengthen economic and territorial one and (2) the term *social cohesion* provides little guidance on which measures might be suitable for promoting and ensuring social cohesion. Therefore, a more detailed definition might be required for providing a more solid legal suitability for art. 175 TFEU, even though art. 174(2) TFEU stresses that «in particular, the Union shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions» where *in particular* seems to stress that not only disparities between regions but also economic and social one should be reduced.

683 Considering art. 175(3), there is nothing that prevents the European Union from adopting a specific policy or scheme for an exclusive part of the European Union, the Euro area in this case. This is also clarified by the European Court of Justice, *Parliament vs. Council*, C-166/07, [2009] when referring to art. 175 TFEU (ex 159 TEC) where the European Court of Justice (ECJ) stated: «45. [The] provision does not set out the form which such specific actions can take», stressing that EU might adopt *an independent policy*. In this way, *specific actions* are not to be decided *ex ante* as they respond to the different and evolving economic and social needs and changes. Still, the Case C-166/07 clarifies two main points: «82.The protean nature of economic and social cohesion and the general nature of the tasks given to that policy mean that it is difficult to define it exactly. It thus proves difficult to lay down the limits of the area covered by the policy because economic and social cohesion emerges as a broad overall concept with imprecise contours». Moreover, there is nothing that hinders the European Union from adopting provision and mechanism for a limited part of the European Union as the Court claimed: «92. [..] There is nothing in the wording of that article that rules out specific action for the benefit of one or more regions of the Community. In addition, if the Community's economic and social cohesion policy is regarded as a device for restoring a balance in order to promote convergence between the regions of the Community, it is perfectly logical that the Community should selectively focus its action on regions which manifest certain economic and social imbalances».

684 Arguably, «the strengthening of its economic, social and territorial cohesion» refers more in generally to promote development of all European Union since one of the objectives is clarified under art.3(3) TEU with

framework to reduce social and economic disparities and promote social cohesion and development. Positive effects to fortify and strengthen economic, social and territorial cohesion must be measured at EU level as the definition of what is covered in these fields fall within the political sphere and should be made in cooperation between the European Union and the Member states[685].

In order to be based upon art. 175(3) TFEU, the EUIS shall be an *ad hoc* instrument, acting as an automatic stabilizer mechanism, for reducing disparities among member states and containing economic shocks. EUIS could be designed to smooth business and unemployment cycles[686].

One of the main problems in creating the EUIS might be identified in fiscal transfers being prohibited underart.125 TFEU (*the no-bail-out clause*). Yet, art. 122(2) TFEU acknowledges the feasibility of providing financial assistance to member states through loans. Hence, it might provide an adequate legal basis for problems related to both economic and financial problems, even though two main shortcomings are surely evident: (1) the limitation to «*natural disasters*» and «*exceptional occurrences beyond its control»* and (2) financial assistance provided on a case-by-case approach to the extent that automatic implementation of the EUIS for economic shocks might be hindered[687].

Moreover, in the context of the creation of EUIS, art. 3(3) TEU (in conjunction with art. 9 TFEU and art. 34 of the EU Charter of Fundamental Rights) seems fundamental, it being aimed at establishing «a highly competitive social market economy, aiming at full employment and social progress», fighting «social exclusion and discrimination» and promoting «social justice and protection, equality between women and men, solidarity between generations»[688].

---

the aim of combatting social exclusion and promoting «economic, social and territorial cohesion, and solidarity among Member States»

[685] On the term «*cohesion*», the European Court of Justice clarified that it is up to member states and the European Union to define instruments for achieving it as it stressed in one of its sentences: «although it follows from Articles 2 and 3 of the Treaty, and also from Articles 130a and 130e, that the strengthening of economic and social cohesion is one of the objectives of the Community and, consequently, constitutes an important factor, in particular for the interpretation of Community law in the economic and social sphere, the provisions in question merely lay down a programme, so that the implementation of the objective of economic and social cohesion must be the result of the policies and actions of the Community and also of the Member States». European Court of Justice, *Portugal vs. Council*, C-149/96, [1999], par. 86.

[686] R. Repasi, ‘’Legal Options and Limits for the Establishment of a European Unemployment Benefit Scheme’’, cit., p. 28.

[687] Art. 122(2) TFEU: «Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken». The Council has given a wider definition of «with severe difficulties caused by exceptional occurrences beyond its control» by referring to art. 122 TFEU (for the establishment of the European Financial Stability Mechanism (EFSM)) to economic and financial crisis that lead to deterioration of national budget and debts. This was stressed in the Regulation no 407/2010 where the Council added that «such difficulties may be caused by a serious deterioration in the international economic and financial environment». Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism, Official Journal, L 118/1 [2010], (2).

[688] Art. 9 TFEU: «In defining and implementing its policies and activities, the Union shall take into account requirements linked to the promotion of a high level of employment, the guarantee of adequate social

Seeking to provide unemployment benefits to short-term unemployed while attempting to achieve a higher standard of social cohesion, EUIS is intended to promote social protection and employment.

Without amending the Treaties, EUIS might be introduced within the current legal framework and objectives. Being aimed at contrasting asymmetric shocks at the European level through shared competences, the scheme would respect both art. 5(3) TEU (*principle of subsidiarity*) and art. 4 TFEU (*shared competences between the European Union and the member states)*.

Furthermore, in cases where the Treaties have not clarified necessary powers or legal basis for certain provisions, the «*flexibility clause*» - spelled out under art. 352 TFEU can be invoked for adopting new actions. Yet, objectives, principles and goals enshrined in the Treaties shall be respected[689]. Art. 352 TFEU might provide an appropriate legal basis, even though it requires an unanimous approval of the Council, provided that they also respect art. 153(4) TFEU[690].

Nonetheless, initiatives taken under the European Unemployment Insurance Scheme (EUIS) for providing fiscal transfer would be subject to art. 125(1) TFEU (*the no-bail-out clause)*, which prohibits financing directly member states and assuming any liabilities. Any member state is responsible for its own fiscal stability, unless there is an explicit legal basis that allows interferences with budgets. Yet, art. 143 TFEU and the Pringle Case have clarified that financial assistance might be provided upon strict conditions[691]. Therefore, financial assistance might be granted provided that

---

protection, the fight against social exclusion, and a high level of education, training and protection of human health». Art. 34 of the EU Charter of Fundamental Rights (*Social security and social assistance*): « (1)The Union recognises and respects the entitlement to social security benefits and social services providing protection in cases such as maternity, illness, industrial accidents, dependency or old age, and in the case of loss of employment, in accordance with the rules laid down by Community law and national laws and practices.

(2) Everyone residing and moving legally within the European Union is entitled to social security benefits and social advantages in accordance with Community law and national laws and practices».

[689] Art. 352(1) TFEU: «If action by the Union should prove necessary, within the framework of the policies defined in the Treaties, to attain one of the objectives set out in the Treaties, and the Treaties have not provided the necessary powers, the Council, acting unanimously on a proposal from the Commission and after obtaining the consent of the European Parliament, shall adopt the appropriate measures».

[690] According to the European Court of Justice « [..]Article 235 [corresponding to the ex-art. 308 TEC and the current art. 352 TFEU] cannot be used as a basis for the adoption of provisions whose effect would, in substance, be to amend the Treaty without following the procedure which it provides for that purpose». See European Court of Justice, *Opinion pursuant to Article 228(6) of the EC Treaty*, Opinion 2/94, [1996], par. 30. Art. 352 TFEU is limited in three aspects: (1) Union action must occur within the framework of the policies defined by the Treaties; (2) the Treaty must not provide or make any reference to necessary powers and (3) an amendment of the Treaty is absolutely prohibited. In addition to, art. 153(4) TFEU claims that «The provisions adopted pursuant to this Article: (a) shall not affect the right of Member States to define the fundamental principles of their social security systems and must not significantly affect the financial equilibrium thereof; (b) shall not prevent any Member State from maintaining or introducing more stringent protective measures compatible with the Treaties».

[691] See. European Court of Justice, *Thomas Pringle v Government of Ireland and Others*, C-370/12, [2012], par. 130-136 and art. 143 TFEU which acknowledges the feasibility of providing mutual assistance «where a Member State with a derogation is in difficulties or is seriously threatened with difficulties as regards its balance of payment».

countries adopt and implement *ad hoc* reforms on labour market, social and unemployment protection and sound budgetary policies.

Beyond these legal bases, transfer funding shall not be ensured. In this way, the scope of EUIS would fall within the scope of the *no-bail-out-clause*, where compliance with art. 125 TFEU could be achieved provided that experience rating, claw-back provisions and the implementation of minimum requirements (under art. 153 TFEU) are introduced. Besides being a suitable and appropriate mechanism for reducing institutional and individual moral hazard while improving stabilization, these requirements could be introduced through an inter-institutional agreement or consensus of governments with the aim of achieving *«social security and social protection of workers»*, under art. 153(1)(c) TFEU[692]. On the contrary, in the absence of these instruments, the EUIS would basically violate art. 125 TFEU and could not be established within the legal framework as it would avoid states the need of implementing reforms[693].

EUIS would also request an appropriate legal basis for *the financing side* of the mechanism either by creating a specific-line linked to the EU budget for contributions to member states or by creating an *ad hoc* external fund for this mechanism, such a European Unemployment Insurance Fund. To this extent, art. 311 TFEU (*Union's own resources)* distinguish two types of resources, «own resources», which should be employed for financing the budget and is defined by a legal act (art. 311(3) TFEU and Own Resources Decision); and «other revenues», which are not defined by any legal act and could be used for specific purposes[694]. Basically, the Union may generate *other revenues* provided that there is a legal basis for it.

The legal bases for including expenditures into the Union's annual budget relies on art. 314 TFEU in conjunction with Regulation no. 966/2012, which according to art. 17 claims that «revenues and payment appropriation shall be in balance».

Since the amount of payments appropriations that are needed for EUIS might exceed the financing capacity of the current Union's budget and since art. 311 TFEU requires unanimity, it would be preferable to act within art. 352 TFEU for raising additional financial contributions to finance EUIS.

---

692 To have a quantitative simulation over the hypothetical impact of the EUIS on the European countries between 1999 and 2012, I suggest to read S. Dullien, ''The Macroeconomic stabilisation impact of a European Basic Unemployment Insurance Scheme'', *Intereconomics*, (2017) p. 192-193.

693 S. Dullien, J. Fernández, M. López, G. Maass, D. del Prado, J. von Weizsäcker, ''Fit for purpose: a German Spanish proposal for a robust European Unemployment Insurance'', cit., p. 16.

694 According to art. 311(2) TFEU, the general Union budget shall be financed from *own resources* without affecting the *other revenues*. Financial contributions and resources to the scheme shall conform with and respect the rules established in art. 311(2), according to which «the Council, acting in accordance with a special legislative procedure, shall unanimously and after consulting the European Parliament adopt a decision laying down the provisions relating to the system of own resources of the Union. In this context it may establish new categories of own resources or abolish an existing category. That decision shall not enter into force until it is approved by the Member States in accordance with their respective constitutional requirements».

Contributions coming from member states might be employed for financing an external fund (outside the Union budget). In this case, a model similar to the European Development Fund (EDF) might be established, namely: (1) a fund that is directly established by member states (and not the Council) and (2) expenditures that are assumed directly by member states and not the Union. As long as there is no exclusive competence of the Union in a specific field and as long as shared-competence is not applied, Member States may set up a Fund, outside the Union's budget. Therefore, since there is no exclusive competence, a fund financing this new scheme could be established[695].

Yet, creating a fund outside the Union's budget might, collide with art. 310 TFEU (*the general principle of unity*) that requires all revenues and expenditures to be part of one EU budget[696]. By using art. 352 TFEU as also the Pringle Case clarified, an *ad hoc* agency, body or institution with its own legal personality might be created where its budget could be used as a fund[697,698]. Alternatively, an

[695] R. Repasi, ''Legal Options and Limits for the Establishment of a European Unemployment Benefit Scheme'', cit., p. 52.

[696] According to art. 310(1) TFEU: «All items of revenue and expenditure of the Union shall be included in estimates to be drawn up for each financial year and shall be shown in the budget». This articles prohibits the separation and any subsidiary of the EU budget within the EU framework. On the contrary, it requires the completeness of the EU budget and the protection of the budgetary powers between the European Parliament and the Council. Nonetheless, a more accurate, precise and restrictive definition of art. 310 TFEU might allow the creation of a separate fund within the EU framework but outside the budgetary law, provided that the European Parliament and Council (in quality of budgetary authorities) exercise their control over the fund as envisaged by art. 310 of the EU budget law. In this way, provided that an involvement of the European Parliament is granted in the supervision, a fund might be established outside the general budget. R. Repasi, ''Legal Options and Limits for the Establishment of a European Unemployment Benefit Scheme'', cit., p. 53.

[697] Currently in the European Union, there exists the European Social Fund (ESF), one of the European Structural and Investment Funds (ESIF) and the main financial instrument for supporting employment and promoting economic and social cohesion within the EU member states. The EFS is, indeed, partnership between the European Commission and the regional and national authorities, driven by two important principles: (1) co-financing and (2) shared management. At the moment, ESF spending amounts to around 10% of the EU's total budget whose mission, according to art. 162 TFEU, is «to improve employment opportunities for workers in the internal market and to contribute thereby to raising the standard of living, [..] to render the employment of workers easier and to increase their geographical and occupational mobility». According to Regulation (EU) No 1304/2013, «The ESF should improve employment opportunities, strengthen social inclusion, fight poverty, promote education, skills and life-long learning and develop active, comprehensive and sustainable inclusion policies in accordance with the tasks entrusted to the ESF by Article 162 of the Treaty on the Functioning of the European Union (TFEU), and thereby contribute to economic, social and territorial cohesion in accordance with Article 174 TFEU». The main problem is that the ESF is used for active employment policy initiatives (expenditures targeted towards improving job-finding probability of an unemployed). Therefore, giving it a passive employment policy function (unemployment insurance) might require a reform or even an amendment of the Treaty.

[698] The judgment of the European Court of Justice (ECJ) clarified in the Pringle Case that member states may conclude and ratified international agreements in those fields, where the European Union does not have exclusive competences provided that these agreement respect some main conditions: (1) they do not modify and amend Primary Law but are rather in line with both Primary and Second Law since their ratification would breach art. 48 TEU (*ordinary and simplified procedure revision*); (2) they do not interfere with exclusive Union competences and shared one. In particular, within the objectives of the Union, international agreements are hindered whenever they cover fields of exclusive competence of Union as clarified by art. 2(1) and 3(1) TFEU. Similarly, if international agreement affects shared competences, then they might be

international treaty or intergovernmental treaty (under art. 175(3) TFEU) might be signed up provided that it respects all the legislative techniques(as it happened with the creation of the European Stability Mechanism)[699]. In both cases, contributions might be risen provided that they do not bypass limitations foreseen in the EU law.

Both legal acts, either for establishing a Union agency or intergovernmental agreement, would require unanimity or a ratification for raising contributions for a fund outside the EU Budget. in accordance with this principle, the procedure would not undermine EU law and would be legally possible.

EUIS could be implemented by involving all participating countries upon art. 20 TEU (*enhanced cooperation)*, which aims at respecting and protecting interests while reinforcing integration, provided that *enhanced cooperation* is in line with art. 326 TFEU and does not undermine internal market and cohesion[700]. However, the hypothetical creation of the EUIS would be done with the primary aim of fostering and strengthening social cohesion among the Euro-countries rather than weakening it[701]. In addition to, *enhanced cooperation* allows (under art. 332 TFEU) the creation of an own fund, outside the general EU budget, to support and finance expenditures of Member States, . As a result, a group of

---

hindered as Union has exercised its competences, under art. 2(2) and 4 TFEU and (3) they are established if enhanced cooperation has failed. Still, they shall respect the *principle of sincere cooperation* under art. 4(3) TEU which stresses that Member states shall «refrain from any measure which could jeopardise the attainment of the Union's objectives». and (4) they shall not bypass legislative procedures or treaties and cannot modify the existing law. According to the judgement, Member States might sign up an international agreement rather than opting for the adoption of a Union legal acts, whenever the Union legislation has not intervened or acted. To know more, see European Court of Justice, *Thomas Pringle v Government of Ireland and Others*, C-370/12, [2012], par. 64 and par. 67. On the contrary, as the Court of Justice clarified, there is only one exception to these rules, according to which member states may conclude international agreements intended as «trustees of the common interest […]in the absence of appropriate action on the part of the Council». European Court of Justice, *Commission vs. United Kingdom*, C- 804/79, [1981], pp. 1075-1076.

[699] Member states might conclude an intergovernmental agreement, within the scope and the objectives of the Union, and only if the *enhanced cooperation* failed or is likely to fail. These agreements are legally valid if they satisfy certain conditions: (1) they do not modify Primary Law, if concluded outside art. 48 TEU; (2) they shall be in compliance with Primary and Secondary Law; (3) they are prohibited if they affect exclusive union competences and shared competence of the Union; (4) they can be concluded if a union legislative procedure failed¸ (5) they can be concluded if enhanced cooperation failed and (6) they do not bypass Union legislative procedure. R. Repasi, ‘’Legal Options and Limits for the Establishment of a European Unemployment Benefit Scheme’’, p. 60.

[700] Art. 326 TFEU: « (1) Any enhanced cooperation shall comply with the Treaties and Union law. (2) Such cooperation shall not undermine the internal market or economic, social and territorial cohesion. It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them».

[701] There are specific legal basis that might be used for attaining the objective of promoting social cohesion, such as art. 21(3) («*measures concerning social security or social protection*»); art. 48 TFEU («*measures in the field of social security as necessary to provide freedom of movement for workers*»); art. 153(2)(b) TFEU (*minimum requirements with regards to working conditions*) and lastly, art. 175(3) TFEU (*specific actions for strengthening social cohesion).*

member states might contribute financially to the Union budget while giving those contributions to a specific budget line of the EU budget[702].

The establishment of EUIS could face barriers at European and national level as amendments to national unemployment insurance and labour market regulation might be needed. Without any doubt, constitutional amendments require a very demanding, lengthy and complex process and negotiations, which might hinder the creation of this mechanism. Indeed, the more heterogeneous and divergent the current national unemployment insurance schemes are, the more numerous obstacles might appear for contrasting both the aim and scope of EUIS[703]. Therefore, the relationship between the European Insurance Scheme and the national one should be deeply studied and analysed before the effective activation of a similar instrument for avoiding a conflict of rules. For instance, it might be guaranteed that EUIS coexists next to pre-existing national schemes where it would be decided which benefit scheme has precedence over the other and which fund would be the financial support.

3.3.3. Designing a debt restructuring framework and a credible no-bail-out clause

The Eurozone crisis highlighted shortcomings and weaknesses in the European Monetary Union. Without doubt, bank failures can directly impact public finances and similarly, political failures might destabilize banks. Not only was the banking system, seriously endangered but also the sovereign debt market was destabilised. Inevitably, a loss of confidence over Eurozone economic prospects was obvious and casted doubt on the credibility of the no-bail-out clause.

To resolve the economic shock, the European Central Bank expanded its tasks under art. 123 TFEU, which clearly prohibits monetary financing of budgets deficits. In these circumstances, the ECB started buying government bonds and securities, not directly from governments but indirectly in the

[702] Art. 332 TFEU: «Expenditure resulting from implementation of enhanced cooperation, other than administrative costs entailed for the institutions, shall be borne by the participating Member States, unless all members of the Council, acting unanimously after consulting the European Parliament, decide otherwise». In other words, EU budget law allows also for a differentiation of revenues provided that enhanced cooperation is in line with the objectives of the Treaties and EU law. In this regard, a revenue differentiation shall be covered by the existing EU law. To confirm this, a former interpretation of the EU budget law allowed for a similar approach when a group of member states (France, Belgium and the Netherlands) decided to support financially (through contributions paid by them to the general budget classified as *other revenues*) a European Project, the so-called High Flux Reactor. Council Decision 2012/709/Euratom on the adoption of the 201-2015 High Flux Reactor supplementary re-search program to be implemented by the Joing Research centre for the European Atomic Energy Community, [2012], OJ L 321, p. 59.

[703] As M. Beblavy and K. Lenaerts stress, in some countries such as France, collective agreements should be adapted to the new framework. Similarly, countries such as Denmark, Finland and Sweden, who enjoy from a Ghent System (unemployment insurance run by trade/labour unions or social partners) and also countries having a liberal welfare system, such as Ireland, Malta, Poland and UK, where insurance is a flat-rated, would undergo fundamental changes. In addition to, in some other countries, such as Austria, Belgium, Bulgaria, Germany, Finland, France, Luxembourg, the Netherlands, Portugal, social partners play a very important role in the design and management of the national unemployment benefits and should be taken into account. On the contrary, in other countries, such as Italy, Latvia, Lithuania, Poland, social partners have a very limited role. M. Beblavý and K. Lenaerts, ‘’Stabilising the European Economic and Monetary Union: What to expect from a common unemployment benefits scheme’’, cit., pp. 12-13.

secondary market. Moreover, different provisions were adopted, such as the European Stability Mechanism (ESM), which somehow contradicts art. 125 TFEU by authorizing the fund to make loans and guaranties to Eurozone countries. Yet, its creation has been an essential and fundamental mechanism for ensuring crisis-management. Even though its existence might be detrimental to fiscal and market discipline, the ESM provides financial assistance in liquidity crisis and to solvent countries[704].

In 2012, the Banking Union has been launched with the aim of ensuring banking supervision and limiting banks' exposures to sovereigns for two main reasons: (1) reducing exposures and occurrence of sovereign crisis and (2) making the Eurozone system much more resilient[705].

Even though the European Stability Mechanism (ESM) and Banking Union have provided further stability, a regime for a credible no-bail-out and debt restructuring should be set up. Sovereign debt crises cannot be excluded in the future as they have not been completely discouraged. Even if the ESM can hinder contagion-risks, it actually induces moral hazard. Countries might continue to accumulate debt while creditors might underestimate market risk.

Besides introducing appropriate fiscal rules in the Eurozone, it is necessary to focus on defeating excessive debt accumulation, it being destabilizing thus increasing default risks[706]. High debt is an obstacle to growth and economic recovery. Yet, as the Greek case demonstrated, Europe has reacted with a more unsustainable solution: austerity[707].

A mechanism to overcome deadlocked situations where the ESM cannot intervene though financial assistance providing assistance should be adopted to cope with insolvency procedures and prevent financial instability. Sovereign defaults can occur in a currency union, if a member country's debt is unsustainable. Therefore, debt restructuring should be accurately evaluated.

Even though the European members have not formally acquired European countries liabilities (such as in Greece and Ireland), the ESM and also ECB have become the main lenders to their sovereigns. In

---

[704] The European Stability Mechanism (ESM) was created with the aim of providing assistance in liquidity crisis through ''loans against reforms'', when market access is lost. By participating in the program, the repayment of the public debt is a duty, even though it is extremely heavy on the limited ESM's financing. Yet, bailing-out created a moral hazard problem as investors expect to be completely repaid back even if they lend to a country that is running a crisis.

[705] R. Barbieri Hermitte, ''Sovereign Debt Restructuring Mechanisms: Mind the trap'', in L. Paganetto (edited by) *Sustainable Growth in the EU,* Basel, Springer International Publishing AG, (2017), p. 107.

[706] A. Bénassy Quére and co., ''Reconciling risk-sharing with market discipline: a constructive approach to euro area reform, cit., p. 10.

[707] There are three ways for countries to fight high debts that have worked in the past: (1) inflation so that debt's real value decreases; (2) economic growth where if GDP increases, debt tends to fall; (3) debt restructuring. Yet, in the Eurozone, the approach has been different. On the one hand, inflation is not allowed due to ECB's mandate focused on price stability. On the other, economic growth is hindered because the European Commission Troika do not allow an indebted country to spend more. On the contrary, European institutions have preferred to sacrifice these two options in favour of austerity. Yet, the latter has lowered down GDP, as in the case of Greece, and national public debt has become unsustainable. Debt restructuring would be the only feasible solution. J. Stiglitz, *The Euro: How a Common Currency Threatens the Future of Europe*, cit., p. 185.

this way, spirit and credibility of art. 125 TFEU have been seriously contradicted. Nowadays, in order to provide an appropriate framework for ensuring fiscal discipline, a more credible no-bail-out clause should be provided and respected. Yet, also an appropriate framework should be created to ensure an efficient debt restructuring between creditors and debtors and reduce contagion risks[708].

Ensuring debt restructuring would be useful for several reasons: (1) creditors would pay more attention to crisis-risks asking more risk-premium on government bonds with high debt, thus enhancing more fiscal discipline and appropriate policies; (2) uncertainty would be reduced as clear rules and processes would be set up; (3) an adjustment burden between tax payers and creditors could be introduced and (4) debt restructuring might allow economic growth and recovery while fostering crisis prevention[709].

Adopting a debt restructuring mechanism, in the Eurozone, could improve the former approach adopted with Greece[710]. Yet, it might encounter political challenges and oppositions, despite European history, identity and integration based on policy coordination, shared vision and goals, common-rule making and institution-building. Nonetheless, removing debt overhangs is necessary to ensure an efficient use of fiscal policy stabilization and adopt expansionary policies, if needed[711]. Undoubtedly, a debt restructuring could affect member states while the expectation of a bailout might reduce fiscal discipline. Yet, countries could actually benefit from a well-structured mechanism for dealing with sovereign insolvency[712].

---

[708] As A. Sapir suggests, a European Sovereign Debt Restructuring Mechanism would be entitled to conduct negotiations between an insolvent sovereign debtor and a creditor to decide how to restructure and reduce the debtor's obligations to establish debt sustainability. A. Sapir, D. Schoenmaker, ''The time is right for a European Monetary Fund'', cit., p. 4.

[709] J. Andritzky, L. Feld, C. Schmidt, I. Schnaebel, V. Wieland, Creditor participation clauses: Making orderly sovereign debt restructuring feasible in the Eurozone, https://voxeu.org/article/mechanism-proposal-eurozone-sovereign-debt-restructuring, published on the 21st July 2016, consulted on the 21st November 2018.

[710] A restructuring in Greece was initially discussed in June 2011 and it occurred in October 2011 through a net cut. The restructuring was completed only in April 2012 and it became one of the biggest and greatest debt restructuring in history.Debt was relieved by 50% of GDP while maturities were extended. Yet, debt sustainability in Greece is still uncertain having Greek debt reached 180% of GDP. A. Jochen, D. Christofzik, L. Feld, U. Scheuering, ''A mechanism to regulate sovereign debt restructuring in the euro area, *Arbeitspapier –Sachverständingerat zur Begutachtung der Gesamtwirschaftlichen Entwicklung*, IV (2016), pp. 3-4.

[711] Eurozone countries have different positions and preferences on debt management. On the one hand, countries with high and unsustainable debt would prefer to see them restructured while the low-indebted countries fear losses and damaging consequences. Moreover, debt restructuring might also encounter debtors' resistance as a similar approach could endanger bank balance sheets. Finally, debt restructuring might be challenged due to a problem of moral hazard. Debt accumulation could be encouraged with the hope that it will be restructured in the future. B. Eichengreen, ''Minimal Conditions for the survival of the euro'', cit. p. 40.

[712] Debt restructuring might be costly because the European Central Bank might be obliged to use monetary policy to prevent feasible default in more weak countries. Similarly, a credible no-bail-out clause is required to ensure both fiscal discipline and debt sustainability. Z. Darvas, P. Martin, X. Ragot, ''European fiscal rules require a major overhaul'', cit. pp. 2-3.

A structure that limits debt accumulation and contains economic debt costs, could be the right response, if supported also by adequate fiscal rules. A centralized debt restructuring, where excessive and unsustainable debt are reduced across the whole Eurozone, could help restore macroeconomic and financial stability in the Eurozone and introduce a risk-sharing mechanism. Debt restructuring would be beneficial as it would increase maturity extension, which reduces liquidity need to repayments and contagion risks while introducing a burden-sharing and equal treatment among creditors. Moreover, debt overhang, it being the first obstacle to growth, recovery and investments, would be reduced[713].

Only when fiscal discipline and low debt levels are achieved, a no bail-out clause would be more credible, it working as an incentive for fiscal discipline while anchoring market participants expectations[714].

Creating the appropriate legal and institutional framework for providing a debt restructuring is necessary for preserving financial stability. Euro area is, indeed, a combination of countries with excessive public and private debt levels, with the exception of Germany (64.1% debt-to-GDP) and Luxembourg (23% debt-to-GDP). Undoubtedly, debt should be reduced substantially to return to a balanced economic growth.

Bailing-out should be allowed only and exclusively where debt is sustainable and a country is facing a liquidity banking crisis but not with unsustainable debt and insolvent sovereign crisis.

In case of another economic shock, a country shall pass the debt sustainability analysis (DSA), according to art. 13 of ESM Treaty, under the European Stability Mechanism (ESM)[715]. This procedure is fundamental to analyse debt structure through an independent assessment by including several and multiple indicators, such as projected debt ratios, historical fiscal performance, past economic performance. Hence, debt restructuring could occur as part of the ESM assistance, where the institution should assess when a country becomes insolvent with an unsustainable debt and in this case, how much debt should be restructured[716].

---

[713] A. Jochen, D. Christofzik, L. Feld, U. Scheuering, ‘’A mechanism to regulate sovereign debt restructuring in the euro area’’, cit., pp. 3-5.

[714] Debt restructuring has already occurred with the Greek government debt involving also private creditors in this process.

[715] Under Art. 13 ESM Treaty, the Chair of the ESM must first ask the European Commission and European Central Bank to conduct an assessment on financial stability of Euro area and to determine the effective sustainability (or not) of a country’s debt. Once the assessment is completed, a decision is taken on financing modalities. Yet, the ESM Treaty does not make any reference to what happens in case of unsustainable debt, even though the presence of a Collective Action Clause (CAC) seems to leave open the feasibility of debt restructuring.

[716] Debt assessment takes for granted that countries with unsustainable debt should not receive financial assistance, unless they restructure their debt. This approach is important for two reasons: (1) the creation of incentives for adopting more responsible fiscal policies implying that insolvent countries have no access to financial support in case of unsustainability and (2) more adequate actions are taken rather than procrastinating debt restructuring. A. Bénassy-Quéré, ‘’Reconciling risk sharing with market discipline: a constructive approach to euro area reform’’, cit., p. 2; p. 12.

Debt restructuring could rely on a two-pillar decision approach. In the first phase, the ESM could require creditors to agree on a *standstill agreement* (an agreement between lenders and borrowers in which creditors stop asking a scheduled payment of interest on a loan to give time to the debtor to restructure its liabilities), before the beginning of the ESM program and financial assistance. For instance, when the debt exceeds a range of 60-90%, maturities can be extended, keeping always as a target the 60% debt-to-GDP-ratio. A similar approach could be quasi-automatic. On the contrary, during the second stage, once the ESM has conducted a more comprehensive debt sustainability analysis, restructuring should occur with the aim of achieving a sustainable level compatible with the ESM financial assistance program[717].

The implementation of an efficient debt restructuring should occur when necessary and at the appropriate moment since it is very difficult to distinguish between liquidity and sovereign crisis at the beginning of the analysis. In an attempt to restore debt to a sustainable level, debt restructuring would be fundamental to ensure market access and receive financial assistance from the ESM.

Implementing debt restructuring would require a solid legal basis for minimizing holdouts. Relying exclusively on Collective Action Clause (CAC) in the Eurozone would not be sufficient to cope with all the legal and practical issues linked to sovereign debt restructuring. On the contrary, the introduction of a «single limb voting procedure», enabling one single vote to start the procedure, might be the right approach[718].

In order to make more credible the no-bail-out clause, two important changes should be adopted. Firstly, improvements in the ESM Treaty should be introduced so that debt restructuring is acknowledged as an essential condition for financial support by the ESM. Secondly, private creditors participation should be included in the different phases of debt restructuring, such as: the definition of restructuring terms with the sovereign debtor (approved by the ESM acting as guarantor); the approval of eligible claims upon a qualified majority of creditors (with an eventual threshold of 75% as most of the CACs); the adoption of a voting procedure on the single-limb to avoid holdouts, possibly created by a blocking minority and finally, a stay of enforcement during a rescue programme, which should be applied in very specific circumstances not to undermine the debt restructuring process[719].

Private creditors should not consider themselves immune since the Greek debt restructuring involved them through the Private Sector Involvement (PSI). Therefore, also a Creditor Participation Clause

[717] J. Andritzky, D. Christofzik, L. Feld, U. Scheuering, ‘’A mechanism to regulate sovereign debt restructuring in the euro area’’, cit., pp. 10-13.

[718] In conformity with the ESM Treaty - under Art.12 (3) - a Collective Action Clause (CAC) has been introduced for government securities with maturity above one year and issued after the 1st of January 2013. Hence, a qualified majority of bondholders can approve a debt restructuring. Nonetheless, the CAC Model is not applied to government bonds issued prior to this date – them being still governed by national law of the issuing country – unless those bonds and securities already include a CAC that allows modifications of the terms. As a result, since there are still sovereign bonds which contain CACs of different type and will mature in the next years, the resolution of sovereign debt crisis might be complicated in the future.

[719] G. Pavlidis, ‘’Designing a Sovereign Debt Restructuring Mechanism for a European Monetary Fund’’, cit., pp. 223-224.

(CPC) should be included in debt issuance, even though it would require further amendments in the ESM guidelines.

Surely, it should be guaranteed that the system cannot be bypassed in no way but rather, every member state should undergo a debt analysis (carried out by the ECB, ESM and the IMF) to verify debt unsustainability and decide where debt restructuring should be proposed[720].

Introducing a framework for restructuring sovereign debt in the medium-long term (up to fifteen years) would enhance credibility in the no-bail-out clause and would even strengthen market and fiscal discipline. Debt restructuring, being supervised by the ESM, would be supported by an adjustment program. Yet, Eurozone fiscal framework might require a significant revision and reform in the treatment of banks' exposures and limitation of debt holdings not to cause economic damages[721].

Debt restructuring might affect heavily other member countries due to the bondholders composition, mainly affected by a home bias. Therefore, debt restructuring in the Eurozone might imply, firstly, an internal redistribution of debt and secondly, a burden of restructuring falling on bondholders in domestic country[722].

By restructuring debt with very simple and transparent rules, uncertainty and economic-financial consequences in crisis resolutions would be reduced while public debt overhang might be defeated provided that a solid legal basis is created[723].

---

[720] Hypothetically speaking, a European Sovereign Debt Restructuring Mechanism (ESDRM) could introduce three different limit-targets to decide when debt restructuring is needed. These might be: (1) in case of compliance with the Maastricht debt-target (60%), restructuring would not be needed; (2) in case of a little excess over Maastricht debt-target, financial assistance would be given, accompanied by fiscal coordination, implying that support would be granted on a conditional basis and would gradually lead to debt-restructuring and (3) excessive debt would automatically require debt restructuring. A. Jochen, D. Christofzik, L. Feld, U. Scheuering, ''A mechanism to regulate sovereign debt restructuring in the euro area, cit., pp. 8-9.

[721] Banks should be asked to limit their sovereign debt's holdings between 25% and 100%. The complex bank-sovereign relation is a direct channel of contagion suggesting that still banking crisis might turn into a sovereign debt crisis. A. Jochen, D. Christofzik, L. Feld, U. Scheuering, ''A mechanism to regulate sovereign debt restructuring in the euro area'', cit. p. 18.

[722] Bondholders' composition is mainly home-based. Domestic investors hold an average of 35% of debt issued by the government, such as in Ireland and Belgium while up to 65% in Italy. Similarly, in Germany, Italy and Spain, 35% of domestic public debt is held by domestic banks while in Ireland and Portugal, most of their debt is held by foreign creditors, which is not subject to debt restructuring. Also in France and Germany, a large share of their debt, amounting up to 30%, is held by foreign creditors, even though it consists of foreign central banks keeping euro reserves. Finally, Euro area investors held a large share of public debt, oscillating from 60% for France up to 90% in Italy. This strong domestic home bias may be the result of domestic investors' expectations. A. Jochen, D. Christofzik, L. Feld, U. Scheuering, ''A mechanism to regulate sovereign debt restructuring in the euro area'', cit., p. 20.

[723] Reducing «legacy debt» is one of the principles that was introduced with the Six Pack and the Fiscal Compact. The debt-reduction rule requires the reduction of debt by 1/20 yearly of the excess over 60% of GDP under Art. 4 of the Treaty on Stability, Coordination and Governance (TSCG or also known as Fiscal Compact). Should all member countries observe the rule, they would respect the SGP in the next years. However, the debt-reduction rule in the Fiscal Compact is simply too demanding and impossible to be realized, especially in a deflationary European context. Practically speaking, for a country like Italy, reducing debt by 1/20 means cutting Italian debt by 50 billion euros per year, which would request a structural reform package harming socially the country.

The Euro area would be a more stable area if countries were given the possibility of restructuring their debt, which should be the last resort, in any case. Being the Greek debt unsustainable (close to 300 billion euros corresponding to almost 180% of GDP), it should be widely accepted that this country needs undoubtedly a restructuring, without aggravating moral hazard and by opting through a maturity extension and further financial assistance by the ESM[724] .

Rather than focusing on the intrusiveness of European fiscal rules, European policy debate should be more concerned with promoting growth, investment and employment in highly indebted countries that have a limited fiscal space to stimulate economy and recovery. Structural reforms and pro-fiscal policies are surely the last tool for solving a debt crisis. Therefore, enough attention should be given to more debt sustainability by introducing a credible no-bail-out clause and debt restructuring[725].

3.3.3.1. GDP-linked bonds: A solution to crisis?

Even though Eurozone has overcome the Big Financial Crisis, Eurozone government debts still remain extremely high with banks holding an excessive quantity of sovereign debt. Uncertainty on growth and financial instability stand as the main problem for the Eurozone economy. Even though Banking Union provides a stricter regulation and supervision in the banking-financial sector, with the aim of reducing moral hazard and risk of crisis, markets have not be sufficiently protected yet.

Despite the adoption of resolution procedures under the Single Resolution Fund (SRF) and the banking bail-in, they might be insufficient steps for preventing a major crisis[726].

---

[724] 70% of the current Greek debt is held by European official creditors while the country has been cut off from private debt markets. Greece needs a debt restructuring to make Greek debt sustainable without fostering additional moral hazard, even though it might be controversial. Yet, two solutions might be adopted: (1) *without creditors commitment to debt relief*, continue financing through ESM should be guaranteed while postponing the returning to debt market and (2) *with creditors commitment and ESM financial support*, debt relief should be started after the ESM program. Relief should occur once a clear timeline and conditions are clarified to minimize the cost of new private borrowing and maximize the chances that relief will work. Hypothesis are to proceed either through maturity extension and deferred interests (an arrangement that allows to pay less interest rates before the promotional period) or face-value debt relief in exchange of a stronger fiscal performance over a period of time. The latter would ensure good incentives for fiscal discipline performance and the fastest approach for restoring debt sustainability. To have a more comprehensive framework of the current Greek debt situation and how it could be restructured, I suggest to read J. Zettelmeyer, E. Avgouleas, B. Eichengreen, M. Maduro, U. Panizza, R. Portes, B. Weder di Mauro, C. Wyplosz,''How to solve the Greek Debt Problem'', *Peterson Institute for International Economics – Policy Brief*, XVIII, X (2018), pp. 1-12.

[725] M. Demertzis, G. Wolff, ''What are the prerequisites for a euro-area fiscal capacity?'', cit. pp. 5-9.

[726] According to art. 125 TFEU, countries should be responsible for repaying their public debt, where in case of loss of market access, a country should default and restructure its debt with creditors. Yet, the Greek crisis showed that no-bail-out clause could not be credible as most of the Greek debt was held by Euro-area banks and brought to a severe sovereign-debt loop. The intervention of Euro members was requested to the extent that they started buying most of the Greek non-tradeable debt. After the Crisis, besides Banking Union, the EU Bank Recovery and Resolution Directive (BRRD) [2014/59/EU] introduced a bail-in tool, which «will therefore give shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during normal circumstances».

Still little has been done to regulate and monitor investors' behaviours and increase their responsibility while limiting the impact of stressful economic conditions[727].

One suitable solution might be the issuing of *state-contingent debt instruments* (SCDIs) and in particular, GDP-linked bonds (also known GDP-indexed bonds). The indexation of the coupon rate would be directly linked to the issuing European-country growth to better manage public debt in a world dominated by uncertainty and instability. Basically, GIBs would link a sovereign debt service payment to its capacity to pay to some variables, such as GDP or commodity prices. Linking debt payments to a nominal GDP-country might help contain imbalances in time of stressful financial instability while containing a costly disruptive debt restructuring and solvency crisis[728]. The Eurozone crisis, indeed, led to an excessive increase in public debt ratios, which have reached historically high levels since the 2000s and have imposed significant constraints on macroeconomic tools. Eurozone countries are now hindered by the zero lower bound (ZLB) and a very limited fiscal space that inhibit fiscal manoeuvers[729].

As the Banque de France stressed, the issuing of GIBs would play a fundamental stabilising role in terms of debt ratio and interest costs. Besides limiting debt levels' deterioration, it would create room for fiscal policies to boost economic growth. GIBs might offer a potential insurance for the whole Euro-area for three main considerations: (1) they introduce a risk-sharing mechanism in the Eurozone markets; (2) they bring more market discipline reducing the overall risk and (3) they make the no-bail-out much more credible as they SCDIs contribute to breaking the bank-sovereign loop while reducing the likelihood of an insolvency crisis.

Contingent debt instruments work as an insurance because banks holding sovereign debt would receive their payments depending on the sovereign's economic condition and performance. Therefore, both issuers and investors would get enormous benefits. In good times, with strong growth, banks would receive a higher payment due to a higher return on bonds, it being linked to higher government revenues. On the contrary, in bad times, they would receive less due to a declining debt service cost while reducing also the need of fiscal consolidation. Basically, in case of negative nominal growth, the coupon rate, which almost hits zero, is not paid on the GIB. As a result, GDP-indexed bonds (GIBs) would have a real countercyclical effect and might also represent a market-based solution to ensure valuable benefits in the Euro-area countries.

---

[727] C. Destais, ''Are state-contingent sovereign bonds the solution to avoid government debt crisis?'', cit. p. 9.

[728] Talking about state contingent debt instruments and especially, about GDP-indexed bonds might surely be premature as global financial-makers and researches have started to conduct analysis only in the last years with the aim of reducing the likelihood of government defaults and financial crisis. Some central banks, such as England, Canada, Germany and France, have advanced considerations over this delicate topic, especially in the contest of the G20, held in Hangzhou (China), in 2016. In this occasion, the 20 biggest economies urged the IMF to conduct «further analysis of the technicalities, opportunities, and challenges of state-contingent debt instruments, including GDP-linked bonds», which it did by publishing, in 2017, a policy paper.

[729] J. Benford, T. Best, M. Joy, '' Sovereign GDP-linked bonds'', *Bank of England – financial stability paper*, XXXIX, IX (2019), pp. 3-4.

Generally speaking, GDP-linked bonds would reduce the risk of payment default which proves costly for both creditors and borrowers and fosters global instability and financial crisis. Basically, where debt is extremely high and volatile - Italy with 131% or Greece with 180% - GIBs might reduce credit spread, which is obviously higher for lower-rated sovereign countries with high default-risk and explosive debt dynamics. Similarly, also for investors, benefits are consistent as GDP-linked bonds would basically provide an equity-like instrument in a country's performance and fortunes. GIBs would provide an investor with a broader hedge (a protection against financial risks) as they protect investors from economic-financial changes, such as standards of living, being the principal indexed to GDP. Significant benefits would thus result for issuers, investors and global economy[730].

State contingent debt instruments (SCDIs) have been already used, as part of the debt restructuring plans in the past, proving even successful in certain cases. Nonetheless, despite theoretical benefits, GIBs have not been issued on the financial markets yet[731].

Even though there are still not occasions in which investors have taken the risk of GDP movements, both in downturn and upturn, with return varying symmetrically, GDP-indexed bonds are highly supported by Banque de France and Bundesbank. Indeed, they are considered a fair solution and tool for a possible sovereign debt-management in case of another financial crisis, in the Eurozone, in contrast to other mechanism previously proposed, such as the *Eurobonds* or *stability-bonds* that received an ambiguous support)[732].

---

[730] C. Destais, ''Are state-contingent sovereign bonds the solution to avoid government debt crisis?'', *Policy Brief CEPII*, XIX, XI (2019), p. 2.

[731] The first prominent use of state contingent debt instruments (SCDIs) appeared during the 1989-97, in the context of the ''Brady debt restructuring''. The Brady instruments offered contingent payments to investors, directly linked to economic variable but they did not forecast any fall in payments in case of an adverse event. Basically, the Brady Deals allowed commercial banks to exchange their obligations on participating countries, which could negotiate terms and details of their restructuring, with tradable instruments, thus allowing banks to clean up their balance sheets. Basically, if an economic or trade improvement in the debtor country occurred, then also creditors would have benefitted by obtaining additional debt service payment. The main problem was that contingent payments were given only in an upside scenario, which effectively occurred. IMF, ''State-contingent debt instrument for sovereign'', *IMF Policy Paper*, (2017), p.20.
Similarly, Argentinian debt restructuring (2005) included the issuing of GDP-linked-warrants, which were initially considered by creditors of little value (implying little gain for them). Nonetheless, under the «soybean boom», their growth boomed in the following years and the warrants exceeded expectations while their prices exploded. More recently, Greece issued GDP-linked securities as part of her debt reduction and restructuring, supported by loans from the EU and IMF. 172 billion euro of Greek debt was exchanged and creditors/holders received GDP-linked securities. At least for the moment, no sovereign has issued marketable GDP-linked-bonds but only GDP-linked warrants (rarely traded and hard to price), which contain an element of indexation to GDP. Nonetheless, in 2015, the former Greek Finance Minister Yanis Varoufakis proposed to exchange rescue loans by issuing GDP-indexed bonds. C. Destais, ''Are state-contingent sovereign bonds the solution to avoid government debt crisis?'', cit., p. 3.

[732] A very heated debate emerged over the creation of *Eurobonds* during the financial crisis as a way for unlocking and overcoming financial instabilities, even though it was already present since the 1990s. Eurobond, which should not be confused with the Eurobond Market (a way for corporations, bank and other entities to borrow money by injecting bonds) stands as a form of full-debt-collectivisation or «bonds-with-a-joint-guarantee» by all the Eurozone countries. Basically, a Euro-country could issue a loan or a bond that

GDP-linked bonds offer several benefits for all the parties involved - issuers, investors and the economy - due to positive externalities.

In exchange for holding an asset that could owe much lower returns, in case of declining GDP, a Eurozone member should pay a premium equilibrated to its risks (*risk-premium*). Being difficult to predict, the risk-premium should be low enough not to discourage bonds-issuing but high enough to attract investors in assuming the risk of the GDP-linked payments, according to a simple criteria: the more volatile the GDP is, the higher the risk premium could be[733].

In case of GDP-linked bonds, the return is directly linked to the growth rate which is extremely beneficial for both the borrower and the investor. The former enjoys limited debt service obligations in case of slowdown and negative growth, thus reducing the possibility of crisis and default. Moreover, it also avoids excessive cut-spending and costly debt-restructuring by stabilizing debt-to-GDP ratio, being kept within a narrower range. On the contrary, the latter reduces cost of debt restructuring and risk of financial crisis while providing an opportunity for risk- and portfolio-diversification for investors (whose volatility might decrease by 12% *on average*) and investments in long-term[734].

Hence, GDP-indexed bonds (GIBs) not only represent a proper and effective form of risk-sharing between Eurozone members, lenders and borrowers but also a sort of insurance, in case of adverse and

---

would be underwritten by the whole Eurozone members implying that if a country cannot service its debt, creditors can ask for repayment from all the other EZ-countries. In this system, borrowing cost would be lower for indebted countries as investors would be confident that stronger countries stand behind the debts. Even though it might very appealing for Italy and Greece, they might be detrimental for other countries, such as Germany, in terms of increasing borrowing costs and political and constitutional problems. Besides national opposition, Eurobonds fail on three grounds: (1) legal; due to art. 125 TFEU; (2) political; as they would require amendments of the Treaties (by 27 member states and not only the Euro-countries) for creating further steps toward a political union over tax-spending issue (taxpayers of ''country-A'' would be liable for decision over spending decision in ''country B'' and fiscal policies for ensuring an harmonization and (3) economic; due to investors' mistrust over joint guarantee and different expectations of the effects, i.e. sovereign credit risk (multiple risk-premia) or increasing debt, influencing also interest rates. In addition to, other problems are related to moral hazard and differences in the national political systems. D. Gross, Eurobonds: Wrong solution for legal, political and economic reasons, https://voxeu.org/article/eurobonds-are-wrong-solution, published on the 24th August 2011, consulted on the 5th December 2018.

[733] As the Bank of England suggests, besides GDP-risk-premium, two different types of premia could be considered: (1) *liquidity premium*, usually demanded by investors, when a bond cannot be easily converted into cash. This is expected to be high initially and fall gradually (once a supply is created) and (2) *novelty premium*, which corresponds to a premium for compensating investors for uncertainties on the instrument. This would be high if the GIBs design is complex. As a result, liquidity, novelty and GDP risk can increase the GIB's premium while containing default risk. IMF, ''State-contingent debt instrument for sovereign'', cit., p. 12-13.

[734] GIBs might offer a new opportunity for portfolio diversification, thus attracting new investors. It is also estimated by the IMF that an investor would obtain higher gains and returns from a diversification through GIBs rather than other financial instruments, such as equities, being related to a lower variance of GDP growth than stock returns. It is also assessed that debt-to-GDP ratio would decrease by 15% on average through GIBs over a time period of 25 years while portfolio's volatility would decrease by 12% on average. B. Cabrillac, L. Gauvin, J.B. Gossé, Benefits of GDP-indexed bonds for issuing countries, investors and international financial stability, https://voxeu.org/article/benefits-gdp-indexed-bonds, published on the 7th March 2017, consulted on the 5th December 2018.

catastrophic shocks, against economic cycle volatility while reducing the probability of unsustainable debt dynamics and default. Moreover, GIBs would be serviced even in case of default.

Basically, a seniority over borrowing and sovereign debt would be given so as to ensure resilience and stability[735]. GIBs would provide an automatic debt relief of only this type of bonds in case of adverse shocks or during a crisis[736].

However, the most significant economic benefit deriving from GDP-linked bonds for the Eurozone countries would be actually the countercyclical feature, it acting as an automatic stabilizer, while limiting the pro-cyclical impact of debt payments[737].

In case of economic downturn, a Eurozone country would basically enjoy a debt relief while reducing default risk for borrowers. On the contrary, in case of economic upturn and strong growth, investors would receive a higher payment. GDP-linked bonds would be a suitable instrument for containing the impact of debt payment on economic cycle[738]. On the one hand, governments may gain a major and additional fiscal space (approximately 10-60% of GDP with a reduction of debt-to-GDP by 15% on average of 25 years); on the other, GIBs would provide an insurance against economic and adverse shocks, such as banking and liquidity crisis, while containing economic and social costs. Indeed, GIBs reduce both pressure for long-term lending and bailouts of sovereigns, making more credible the *no-bail-out clause* as private creditors would play a greater role[739].

---

[735] As the Bank of England stated at the International Capital Market Association (ICMA) 2016 stated: «"The net practical effect of [the GDP-linked bonds] economic characteristics and legal features is to create an instrument which is more likely to continue to perform and remain in the markets in times when the sovereign finds itself in a challenging economic situation giving the GDP bond a practical seniority over other sovereign borrowings, which should facilitate growth in the market for the instruments».

[736] The main problem of public debt is that they lack a clear seniority structure, exposing an already fragile and highly indebted countries to further instability. On the contrary, in case of insolvency of a financial institution, its liabilities are repaid according to a pre-defined order of seniority: firstly, shareholders' losses and secondly, convertible debt's holders. G. Tabellini, Reforming the Eurozone: structuring versus restructuring sovereign debts, https://voxeu.org/article/structuring-versus-restructuring-sovereign-debts-eurozone, published on the 23rd November 2017, published on the 4th December 2018.

[737] GDP-indexed bonds (GIBs) are now seen as a way for governments to exit a recession by shifting the burden of adjustment from taxpayers to investors in economic downturns. Basically, in case of weak growth, debt service costs would decline while its debt-to-GDP stabilises. On the contrary, in case of strong growth, governments would benefit from higher revenues. Hence, the return on the GDP-linked bond would increase conforming to the repayment capacity. R. Shiller, J. D. Ostry, J. Benford, M. Joy, Sovereign GDP-linked bonds: Rationale and design, https://voxeu.org/article/sovereign-gdp-linked-bonds-rationale-and-design, published on the 16th March 2018, consulted on the 5th December 2018.

[738] M. Demertzis, S. Zenios, ''State contingent debt as insurance for Euro-area sovereign'', cit., pp. 8-10.

[739] As J. Ostry suggests, in order to have a meaningful improvement in fiscal space, a country that starts linking 20% of its total debt stock in GIBs might benefit from a raise around 15 points of GDP over its maximum sustainable debt-to-GDP ratio which would be enough to absorb the cost of an hypothetic banking crisis. R. Shiller, J. D. Ostry, J. Benford, M. Joy, Sovereign GDP-linked bonds: Rationale and design, https://voxeu.org/article/sovereign-gdp-linked-bonds-rationale-and-design, cit.

GIBs would have enormous benefits in case of debt restructuring, which is absolutely needed not only for Greece but for several European countries[740]. Being debt service payment adjusted directly to GDP with nominal value directly linked to a country's growth, they offer a shelter from insolvency and reduce the probability of default and costs of debt-restructuring. Not only do GIBs give investors an incentive for debt relief in exchange of higher returns in better times, but they also avoid the need of further debt relief in the future. Basically, they help contain losses in time of restructuring while reducing both negative growth shocks and avoiding lengthy, complex and costly delays in reaching an agreement between the parties. GIBs allow to backload debt re-payments until when a country's recovery is achieved.

Moreover, they are advantageous because they encourage a diversification of funding base. Hence, not only is the system more resilient but sovereigns get also financing from a wider range of investors, in normal and good times, while spreading risk-sharing in case of stressful episodes.

Improving risk-sharing in the market, supported by a complete Banking Union, could help reduce moral hazard, instability and market fragility in the Eurozone. On the one hand, GIBs could strengthen Eurozone monetary and financial system as they would contribute to expanding and broadening the set of available financial instruments while providing a more efficient risk-sharing mechanism[741]. On the other hand, completing Banking Union is needed to reduce banks' exposures to sovereign and general risk while breaking the doom-loop[742].

State-contingent debt instruments, such as the GDP-indexed bonds, would help reduce also the speed at which sovereign fragilities may directly affect banks' structure and health as its stabilization properties would reduce risk-defaults while supporting countries in overcoming distressful situations

[740] To have a quantitative view on the countercyclical effect through GIBs, I suggest to read D. Bonfim, D. Pereira, "GDP-linked bonds: design, effects, and way forward," *Economic Bulletin and Financial Stability Report Articles and Banco de Portugal Economic Studies, Banco de Portugal, Economics and Research Department*, (2018). They, indeed, demonstrate that interest savings from the issuance of GIBs would have a direct impact on fiscal policy and primary balance, where the correlation between GDP and primary balance would be extremely higher. From their quantitative analysis, GIBs would provide a symmetric fiscal adjustment: lower risk and pressure on interest payment in bad times while in good times, the channeling of fiscal revenues to interest expenses is ensured. Moreover, they also demonstrate that countries such as France, Spain and Portugal would have fully complied with the 3% rule imposed by the SGP, had GIBs been earlier adopted. Without these instruments, it seems that the 3% deficit-threshold constraints the ability of conducting countercyclical fiscal policies within the Euro countries. GIBs would enhance a countercyclical fiscal space. Savings would create room for less pro-cyclical fiscal policies without compromising fiscal sustainability.

[741] J. Benford, T. Best, M. Joy, '' Sovereign GDP-linked bonds'', cit. pp. 13-14.

[742] The launching of the Banking Union has already provided some tools for weakening the doom-loop between banks and sovereign. Under Directive 2014/59/EU, the bail-in «with the objective of restoring the capital of the failing institution to enable it to continue to operate as a going concern» has been introduced for cushioning and absorbing shocks so as to reduce the need for a bail-out. In such way, bank's fragility and liquidity crisis stand as a less serious danger than it used to be.

in the most limited time. Being GIB's response automatic, they could limit the impact of negative spill-overs from one Eurozone country to the others[743].

Surely, coordination should be fostered for encouraging Eurozone countries to issue GDP-indexed bonds. Besides transforming Eurozone in a more stable currency area, with a risk-sharing mechanism in the markets, countries would enjoy enormous benefits, some more than other, as each country would pay its premium equilibrated to its risk[744]. In addition to, GIBs are well-functioning and potentially useful when both debt-to-GDP ratio and volatile interest-growth differentials are high, as in Greece, Belgium, Spain, Portugal and Italy. On the contrary, countries with a less-volatile interest-growth and a low debt-to-GDP ratio would enjoy less benefits[745].

Undoubtedly, sovereign contingent debt instruments present some challenges, such as the definition of risk-premium, having the price an impact on fiscal space and on growth and a problem coordination. Yet, Euro-area countries would pay the risk-premium to avoid another debt crisis.

These instruments should not only be tailored to the needs of each country but they should also fairly and adequately priced. Hence, several parameters should be adopted to counterbalance GDP-volatility. Similarly, the definition of the GDP-price should be eventually not given to the country itself but rather to an independent and reliable institution, such as ECB or Eurostat, that conduct trustworthy statistics.

Sovereign contingent debt instruments could be a financial innovation able to enhance financial stability in the Euro-system and bring a solid insurance for Euro countries against further crisis, adverse shocks and periods of low growth rate, being the country's debt payment directly indexed to its economic performance. Risk-sharing in the market could thus enhance a system-wide risk reduction.

Moreover, the adoption of this instrument would not necessarily require amendments in the Treaties but rather an efficient coordination for issuing GIBs. Yet, even though, they might seem an attractive, appealing and technically viable tool, with enormous advantages in terms of default avoidance and global financial stability, limited market developments can be explained through the «first-mover

---

743 J. Benford, T. Best, M. Joy, '' Sovereign GDP-linked bonds'', cit. p. 13.

744 In a simulation conducted by M. Demertzis and S. Zenios, they demonstrate that issuing GDP-indexed bonds would be extremely beneficial for two reasons: (1) system-wide benefits deriving from weakening the bank-sovereign doom loop and (2) risk-aversion. Basically, risky countries would suffer less from adverse economic shocks, in contrast to booms and good performances when they would pay more. A similar mechanism would allow to decrease both default risk while almost making null reoccurrence of debt crisis. By strengthening weaker links, spillover effects would predominate. Similarly, since also robust economies, like Germany and France, undergo recession, they would benefit from decreasing interest payments as well. M. Demertzis, S. Zenion, ''State contingent debt as insurance for Euro-area sovereign'', cit., p. 16.

745 J. Acalin, Turning national growth-indexed bonds into European Assets: A proposal to strengthen the Euro-area, https://voxeu.org/article/turning-national-growth-indexed-bonds-european-assets, published on the 10th October 2018, consulted on the 5th December 2018.

problem»[746]. Nonetheless, in order to bypass and overcome this obstacle, an *ad hoc* European institution could be created to coordinate the issuance of Eurozone GDP-indexed bonds, provide technical support, respecting data integrity and statistical transparency and enhance market structure and its development for spreading credibility among investors[747]. In this way, moral hazard could be reduced, even though initially, this mechanism might deal with refinancing the existent debt and resolving debt burdens of post-crisis countries, such as Greece and Italy[748].

Surely, the translation of this idea into practice might encounter a series of problem and difficulties. The main concerns include the need of finding a deep pool of investors; an appropriate test issuance for countries issuing GIBs (being GDP difficult to measure due to constant revisions); whether bonds should be indexed to nominal or real growth and lastly, moral hazard since higher growth leads to higher interest rates payment thus reducing incentives for promoting policies for growth.

---

[746] Issuer might be quite reluctant in opening the GIB-market as they would have to pay a premium to attract investors to buy bonds and create the markets. Yet, sovereigns might benefit from lower pricing once the market properly develops.

[747] Since it seems rather unlikely that GIBs will be issued by individual countries in the Euro area framework, there are proposals on the creation of an *ad hoc* institution, such as the European Debt Agency (EDA). Besides ensuring coordination, the EDA would buy GIBs directly from the Euro-countries. In this case, the buying price of the GIB should be such that the expected return is equal to the return on a *plain vanilla bond* (the standard type of a financial option). Hypothetically speaking, market discipline would be imposed on the most indebted Eurozone countries while ensuring that the sovereign risk is not mispriced. The EDA would operate in such a way that they gather all the GIBs and collect the premium. Last, it would issue a safe European bond, with a low and fixed interest rate. J. Acalin, ‘’Turning national growth-indexed bonds into European Assets: A proposal to strengthen the Euro-area’’, cit. However, there are other proposals on using the already existing ESM and private financial intermediaries, such as rating agencies.

[748] Several simulations have been performed by the IMF and Banque de France on the impact that GIBs could have had in the Greece’s case. Had half of Greek Public Debt converted in GIBs in 2009, more favourable conditions for both the economy and the government debt would have occurred. In 2015, indeed, the Greek Finance Minister, Yanis Varoufakis, proposed an effective Greek debt swap with Eurozone creditors and investors through GIBs. Conceived as a «smart debt engineering» rather than a debt-cut, benefits would have been evident for Greece, even though it could be perceived as a loss for taxpayers and creditors. Debt restructuring would have been avoided since debt would have been automatically adjusted to lower levels. GIBs would have offered substantial gains for the country and creditors as Greece’s debt service would have been much more contained while countercyclical policies could have been adopted to ensure faster recovery and ‘’softer’’ recession. Moreover, investors would have kept the full nominal value of their bonds and would have compensated interests’ losses (since 2014) through the surplus generated by the economic recovery (ranging from 1 to 1.5% of GDP). GIBs’ principal repayments are, indeed, indexed to nominal growth, which cannot lose value thus avoiding heavy cuts for investors. Likewise, in time of crisis, debt service decreases while the coupon rate (the interest rate paid on a bond by its issuer for the term of the security) is not paid on the GIB debt. On the contrary, in time of upturns, savings generated are expected to be injected into public spending, creating a surplus in growth while decreasing or, at least, stabilising debt levels to GDP-indexation. Even though this proposal was supported by Germany as Greek default would have been avoided, the ECB strongly opposed. Financial Times, T. Barber, Greece finance minister reveals plan to end debt stand-off, https://www.ft.com/content/7af4252c-ab03-11e4-91d2-00144feab7de, published on the 2nd February 2015, consulted on the 7th December 2018. Banque de France, EcoNotepad, B. Cabrillac, L. Gauvin, J.B. Gossé and F. Lalanne, GDP-indexed bonds: a solution to debt crises?, https://blocnotesdeleco.banque-france.fr/en/blog-entry/gdp-indexed-bonds-solution-debt-crises, published on the 19th April 2018, consulted on the 7th December 2018.

Without doubts, SCDIs can raise important challenges in terms of indexation and complexity due to high-risk premiums, pricing and low liquidity as the first country to introduce these instruments might pay the greatest premium. However, the more countries will issue them, the lower the premium and the greater portfolio diversification will be. Nonetheless, as also some analysis conduct by the Banco de Portugal, IMF and Banque de France demonstrate, Euro area countries might surely benefit from GIBs, them being affected by high debt levels, volatile interest rates-growth rates and constrained by the ability to respond to domestic business cycles through an autonomous monetary policy. GIBs would help address these issues, preserve policy space and reduce uncertainty around the debt-to-GDP ratio for Euro in bad times while having access to a wider investors' base within the European Union, allowing cross-border risk-sharing and reducing risk of data manipulation[749].

Before issuing in reality these bonds, further analysis should be conducted to evaluate whether they will be efficient also in the market[750]. Moreover, these new mechanisms would not replace all sovereign debt but they would rather offer a diversity of instruments for improving investors' funding base and system's resilience while ensuring a full debt-stabilization over the business and economic cycle, as also Greece proposed.

[749] D. Bonfim and D. Pereira have demonstrated the countercyclical effect Euro-countries would have benefited from. Had the Euro area countries started issuing GIBs between 2000 and 2015, they would have benefitted from a 4.34% coupon rate, with much lower interest rates in time of recessions (between 2008-2009 and then 2012-2013) while they would have been compensated by higher interest rates in upturn times (2000, 2006 and 2007). Moreover, in time of sovereign debt crisis, the most affected countries (Spain, Greece, Ireland, Italy and Portugal) would have paid less coupon rate, 4.09% compared to 4.35% with lower interest savings, 0.08% compared to 0.13%. D. Bonfim, D. Pereira, "GDP-linked bonds: design, effects, and way forward," *Economic Bulletin and Financial Stability Report Articles and Banco de Portugal Economic Studies, Banco de Portugal, Economics and Research Department*, (2018), pp. 22-24.

[750] On the feasible approaches to issue GIBs both in the Euroarea and internationally, see G. Makoff, ''GDP-indexed Bonds: A way forward'', *Policy Brief Centre for International Governance Innovation,* XCVII (2017).

CONCLUSIONS

Whether we can talk of a «Euro-success» or a «Euro-failure» is surely a point of debate. Imperfections and inefficiencies in the Euro architecture are evident and incompleteness quite obvious. Even though the process of European integration has created something unique and without precedents – the European Union, the Economic and Monetary Union and lastly, the Euro - the economic integration has not been optimal.

On the one hand, the European Union is now acknowledged as one of the most incredible and stunning form of cooperation among European states that overcame intense hostilities after decades of atrocious wars on the European continent. A strong popular support is, indeed, confirmed by the «*fairly positive image*» European Union has now gained among European citizens, as the Eurobarometer stresses.

On the other hand, even though the Economic and Monetary Union with one single currency, the Euro, has obtained an impressive support, it has not brought the brilliant results expected in terms of growth, prosperity and employment. Rather, a dismal performance has appeared on the European scenario to the extent that the launching of the Euro has exacerbated heterogeneities, creating a real distinction between the *Core* and *Periphery* countries.

The ratification of the Maastricht Treaty (1992) - with the launching of the monetary union and the Euro - might have been extremely ambitious, despite the great support now achieved, as also the Eurobarometer confirms.

From the standpoint of a pure and mere economic analysis, the Eurozone should have not been created. Indeed, there were not sufficient structural conditions, in terms of economies, factors mobility and similar monetary preferences, for creating it. Rather, European countries should have probably stopped to the creation of the Single Market (1985), which was already an ambitious project and an incredible form of cooperation.

Not only were economic conditions disrespected under the Optimum Currency Area (OCA) Theory but also the Convergence Criteria chosen were based on a nominal evaluation process rather than a real one.

Bypassing the necessary conditions and being leaders driven by a political pro-European enthusiasm, real economic merits were left apart and politics won over economics. Inevitably, an inadequate assessment was made.

Nowadays, nobody can know what would have happened had European countries respected (at least) the convergence criteria chosen, without any exception or escape clause. Probably, the final outcome would have been better and more successful in terms of economic and social convergence while the serious Eurozone double-dip financial crisis (2009-2012) could have been avoided. On the other hand, more countries would have been left out of the process and would have suffered the heavy consequences of the crisis that hit Eastern Europe during the same crisis. Yet, what we know is that we live in a highly indebted currency area with high unemployment rates (especially, the youth one) and a growth lower than the one expected.

Since the Eurozone is here to stay and to be part of our lives having gained a significant credible voice and support at international level, ameliorations to the current unstable Euro-system are surely needed. On the one hand, a more solid economic structure and governance are needed; on the other, two main considerations deserve a special attention.

Firstly, dismantling Euro as the best feasible solution for European countries for regaining competitiveness and a better-off economic condition is an illusory and simplistic idea that should be sooner or later abandoned, as I demonstrated in my thesis. Financial chaos accompanied by a general political panic could result in a destabilizing effect, whose cost and impact might be so intense to cause «*the mother of all financial crisis*» and a loss of credibility both at European and international level.

Volatility associated also with an enigmatic and challenging approach on how to proceed could appear on the market being Art. 50 TUE an inappropriate legal basis on which to rely. Besides being exclusively applicable for member states willing to leave European Union, it is also difficult to apply, as also the current Brexit negotiations are showing.

The Euro having been introduced as an *irreversible step*, nobody has ever contemplated the idea of dissolving it for the meaning attached to it and the effort made for proceeding in this way. Underestimating the impact of dissolution could be more harmful than the effective launch as the level of integration in terms of rules, laws, normative and treaties is now so high that dismantling could require an even higher cost.

Secondly, even though fiscal union is often presented as ‘’the cure to all Eurozone’s problems’’, I concluded it might have the opposite effect by exacerbating dissatisfaction and heterogeneities with the risk of a *one-size-fits-all principle* also in the fiscal field and a *differential integration* where some members-states would be more integrated than others. Creating an even more multispeed Europe - under the «those who want to do more do more» suggestion - would rather risk amplifying the already divergent economic situation.

In addition to this, being Europe ‘’threatened’’ by a right-wing populist-wave, I do not think the European Union and especially, the Eurozone, is actually ready to take a further ambitious step in this direction. On the contrary, I personally think that if fiscal union will be ever created, it will be a limited one.

Nevertheless, without any doubts, the Euro has contributed to creating one of the most powerful single markets in the global scenario in which states have benefitted from lower transactions costs, lower inflation and higher credit rating and have exploited (almost fully) the four freedoms: capital, services, people and labour. The Euro has also become the second most important currency in the global scenario – it being used by more than 340 million people, accepted by a vast majority of European citizens and having transformed the European market into a solid, unified and competitive economic block. Yet, a condition based on «a muddling-through» is not conceivable anymore.

In the last years, most of the Eurozone financial stability has been provided by the creation of one of the most credible and evolving institutions, the European Central Bank, capable of responding to unpredictable financial shocks by activating a series of unconventional policies in an attempt to shelter Eurozone collapse through Outright Monetary Transaction (OMT), Securities Market Programme (SMP) and Quantitative Easing (QE). Even though the QE Program has had a very modest but beneficial impact for Eurozone recovery, the ECB has helped avoid a real financial collapse.

Among all the European institutions, the Central Bank is probably the one that has undergone the most relevant changes in terms of policies. Not only it did abandon the conservative monetary approach, but it has also launched a Banking Union Project (2012), which is however still incomplete.

In the medium to long term, a European Deposit Insurance Scheme (EDIS) will become unavoidable – in line with the current legal framework under art. 114 TFEU - as a right response to ensure further stability, risk-sharing within the monetary union and to spread trust and confidence while breaking the vicious circle between banks and sovereign and reducing bank exposures to government debt that might cause a financial crisis.

EDIS might be the mechanism for further integrating financial markets and creating a credible safety net while reducing risks of systemic crisis. Being the Eurozone *an irreversible bank-based system*, a solid European banking union will be needed for providing a major stability of the Euro. Keeping banking and financial supervision and monetary policy as two distinct spheres might be dangerous and risky.

Despite some significant ameliorations, the Eurozone is still a ‘’crippled system’’ which risks to be still exposed to instabilities, fragmentation and uncertainties.

To come to terms with that, due to the expansive and new legal tasks the ECB has gained under art. 127(6) TFEU, a revision of its Statute will be inevitable sooner or later. Even though great obstacles might occur due to the unanimity rule required, a major transparency, accountability and resolution of a perceived *democratic deficit* shall be compensated for the new tasks acquired.

Even though it reluctantly accepts it, the ECB is now more focused on financial stability than it used to. Hence, sooner or later, the ECB should recognise financial stability as a primary objective (in conjunction with price stability) and overcome its current business model still prevalent in Frankfurt.

More precisely, focusing on the definition of price stability and inflation target, the asymmetric and ambiguous impact of the «*close but below 2%*» clause has been quite evident. Being the definition contained neither in the Treaty nor in the Statute, the Governing Council of ECB could better clarify and, eventually, adapt a new definition to the current economic conditions, hit by the zero-lower-bound (ZLB) - for supporting European recovery and growth. As also the Vice-President of the ECB, Vitor Constancio, noted, a slight increase in the inflation target accompanied by a revision of the two-pillar strategy might be necessary.

Despite an intense transformation process, the ECB should maintain, however, its independent position without exercising any pressure for the introduction and application of structural reforms, as it happened with the negotiations between the Troika and Greece.

Undoubtedly, great developments have occurred since the end of the financial crisis but there is still a long way to fully enjoy benefits deriving from a common destiny under the Euro.

EDIS alone cannot ensure the cross-border financial risk-sharing mechanism needed within the Eurozone. For this reason, a proper Banking Union should be established in the medium-long term in conjunction with the completion of a Capital Market Union (CMU) for ensuring a better portfolio diversification and funding system - in terms of equity and ventures. Since volatility of the interbank market and banking financing have been among the main causes of financial shocks, the Eurozone should adopt valid alternatives rather than relying exclusively on a bank-based financing.

A Capital Markets Union, accompanied by a completed Banking Union, would be sufficient to enhance a better regulation and supervision of financial markets and European economy and absorb losses from feasible crisis and systemic risk. Undoubtedly, completing both projects is a very ambitious target since financial integration requires also significant changes and a certain harmonisation of policies and legislation.

Since financial stability is the result of interaction of different institutions, the ECB cannot act alone. Rather, European institutions should work together for providing the right setting for the different European economies while respecting the fiscal diversity that characterizes the Eurozone. It is, indeed, necessary to reduce Eurozone countries' overreliance on the ECB, used as a countercyclical weapon.

Being the Eurozone fiscal rules evidently inefficient, complex and asymmetric, and an overregulated framework having been created under the Stability Growth Pact, Two-Pack, Six-Pack and lastly, Fiscal Compact, a more appropriate revision focused on the real needs of European economies would be much more appropriate for providing also a counter-cyclical support.

By adding rules over rules, European countries are not only hindered from respecting them but when they fail in complying with them, they are even punished through sanctions that simply undermine an already precarious and unstable economic scenario.

To ensure a well-functioning fiscal system, simple, clear, efficient, adequate, rewarding and flexible rules should be established. Rather than extending a pro-cyclical 3% threshold to all European countries, which imposes the same limit both in good and bad times, the introduction of a very simple, clear and countercyclical policy (hypothetically, the mentioned *operational rule*) might be eventually a more appropriate approach.

The structural internal conditions and business cycle of a European country should be taken into account for providing a more appropriate analysis, ensuring fiscal prudence and lastly, avoiding moral hazard. Similarly, excess surpluses and deficits should be symmetrically treated where they should be adequately contained for avoiding excessive imbalances that might still be source of further financial distresses.

The failure in coordination within the Eurozone is the proof that the current framework is the wrong setting and approach for ensuring stabilisation and fiscal discipline in the Euro-area.

Surely, the creation of new fiscal rules might be a costly and challenging process. Yet, the creation of a more efficient framework shall be a priority due to the veil of discontent and dissatisfaction felt and inadequacy for meeting European needs.

Without subverting the current legal framework, under the art. 126 TFEU, if used as a starting point for providing a new fiscal framework, a solid ground might be found.

In the past, European countries and leaders have given proof of collaboration to the extent that both reforms and the ratification of new treaties have occurred over the years, since the very origins. Cooperation is, indeed, at the very basis of the European project to the extent that European countries have in multiple occasions been able to adopt new tools and provisions in distressed scenarios.

One of this has been the creation of the European Stability Mechanism (ESM) - under the amended art.136 TFEU - that has been fundamental in time of crisis by providing financial assistance to European countries.

Bypassing art.125 TFEU (*no-bail-out-clause*), the European institutions and states have acted activating bailout packages for saving countries enormously hit by the financial crisis, such as Greece, Spain and Ireland. In order to avoid a financial collapse, the credibility of this principle has been put into question while raising now a problem over moral hazard. Moreover, the conditions imposed have been surely too strict – probably influenced also by the excessive role of IMF –that solidarity and support might have been deeply hurt with Greece feeling that the spirit of cooperation and collaboration on which Europe relies was betrayed. Rather than a mutual support and a *de facto* solidarity, Greece has been punished for its profligacy.

Eurozone should now learn from its mistakes recognising that bombing a country with an ‘’hasty austerity’’ - as also the President of the European Commission, Jean-Claude Juncker, recently admitted - might not be the right approach for solving problems. It has never been and never will.

Even though the ESM has provided assistance and financial coverage through loans – under art. 12 ESMT - and stands as a more or less efficient crisis-management tool, some crucial points are still left open. The voting mechanism based on unanimity slows down decisions for providing financial assistance while technical assessment for monitoring debt sustainability and conditional nature of financial assistance might be better structured.

ESM competences should be improved or eventually, expanded to cope promptly with financial instabilities that might occur again.

Besides analysing the conditions under which it would be possible to financially support a country due to market loss, a debt restructuring mechanism should be allowed, also in the country’s interest, whenever an adjustment programme does not work and debt is excessive and unsustainable. A similar approach might also be supported by exchanging bad debt with safe provision, such as with the GPD-linked bonds here hypothetically mentioned.

The Eurozone should make the best from the former financial crisis. Greece conditions are so terrible that living standards, growth and employment rate have simply collapsed while debt restructuring was delayed when asked. Hence, when possible, IMF intervention should be absolutely avoided.

Orderly default or debt restructuring should be ensured as a last resort within the Eurozone provided that this process is accurately driven and its costs contained. A more adequate mechanism acting as a moderator or intermediary to reschedule negotiations and terms between creditors and debtors should be established. Depending on the type of crisis, conditionality on financial assistance, after an assessment, should be contained in an attempt to overcome a vicious circle of monetary transfer and dependence.

By ensuring debt restructuring, a credible no-bail-out clause would be re-established while risk-sharing, market and fiscal discipline would be encouraged. Indeed, creditors would pay more attention to risk of crisis on government bonds while *ad hoc* clear rules would be laid down thus improving the former approach adopted with Greece. Moreover, besides creating a credible regime, debt restructuring would focus on defeating the excessive debt accumulation, which is enormously destabilizing and risks raising further default risks.

Only when fiscal discipline and low debt in the Eurozone will be achieved thanks to debt restructuring, a no bail-out clause would be more credible.

By creating the appropriate framework for avoiding legal and institutional hold-outs, debt restructuring would be applied for preserving financial stability while coping with all the legal and practical issues. The Euro area is, indeed, a combination of countries with excessive public and private debt levels.

Yet, the banks and financial integration should not be the exclusive subject of most attentions. Within the Eurozone, nineteen different economies - with million people living in - are grouped into one monetary block affected by asymmetric and divergent shocks.

Too often the European institutions are perceived not only as very detached from European citizens but also as excessively technocratic. Therefore, mechanisms for ensuring a resocialization in Europe are absolutely needed as well as for providing the Eurozone with a shock absorber instrument. An automatic adjustment mechanism should be created as this gap is too costly in terms of competitiveness, growth and (un)employment rates.

In this thesis, I hypothesized the creation of a European Unemployment Insurance Scheme (EUIS) based on a fiscal transfer system, within the current legal framework so as not to breach art. 125 TFEU.

Being the Eurozone affected by very low labour mobility and capital mobility, alternatives shall be found. Hence, a feasible solution might come through *temporary transfers* for containing national and regional short-term cyclical unemployment downturns and negative spill-overs that might have a very destabilizing effect at European level. A similar mechanism might be helpful also for creating a much stronger solidarity among the Eurozone citizens and workers.

To conclude, since the Eurozone is not made only of banks and private institutions but also of millions citizens, social cohesion, mutual support and solidarity shall be re-discovered among European countries for keeping the promises made.

It is high time that Europe and, specifically, the Eurozone countries, remember of their forgotten motto: «*In Varietate Concordia*» (United in diversity). A history of policy coordination, shared vision and goals, common-rule making and institution building stands, indeed, as part of European integration and identity.

BIBLIOGRAPHY

Alesina Alberto, Tabellini Guido, Trebbi Francesco, ‘’Is Europe an Optimal Political Area?’’, *Brooking paper on economic activity,* XII, I (2017), pp. 169-234

Alexander Kern, ‘’Sovereign debt restructuring in the EU: Lessons from the Recent Crisis’’, in Delimatsis, Panagiotis, Herger, Nils (edited by), *Financial Regulation at the Crossroads: implication for supervision, institutional design and trade, international banking and finance series,* Alphen aan den RijnKluwer, Law International BV, (2011), pp. 160-161

Amann Edmund, Baer Werner, ‘’Market integration without policy integration: a comparison of the shortcomings of Mercosur and the Eurozone’’, *Latin American Business Review,* XV, III (2014), pp. 327-335

Andor László, ‘’Basic European Unemployment Insurance – The best way forward in strengthening the EMU’s resilience and Europe’s Recovery’’, *Intereconomics,* XLIX, IV (2014), pp. 184-203

Andor László, ‘’The unifying role of the single currency’’, *Intereconomics,* LIII, IV (2018), pp. 215-220

Andritzky Jochen, Christofzik Désirée, Feld Lars, Scheuering Uwe, ‘’A mechanism to regulate sovereign debt restructuring in the euro area‘‘, *Arbeitspapier –Sachverständingerat zur Begutachtung der Gesamtwirschaftlichen Entwicklung,* IV (2016), pp. 1-26

Anesti Anil, ‘’The Myth of Eurosclerosis: European Integration in the 1970s’’, *L'Europe en Formation,* CCCLIII, III (2009), pp. 39-53

Aslett Kevin, Caporaso James, ‘’Breaking up is hard to do: why the Eurozone will survive’’, *Economies,* IV, IV (2016), pp. 1-16

Baimbridge Mark, Whyman Philip, *Crisis in the Eurozone: Causes, Dilemmas and Solutions*, Houndmills, Palgrave Macmillan, 2015, pp. 1-138

Baldwin Richard, *The economics of European integration*, Berkshire, McGraw-Hill Higher Education, 2009

Baltas Nicholas, ‘’Strengthening the Economic Governance of the Euro Area’’, Athens university of economics and business, *Working Paper Series,* XX (2013), pp. 1-9

Barbieri Hermitte Riccardo, ‘’Sovereign Debt Restructuring Mechanisms: Mind the trap’’, in Paganetto Luigi (edited by), *Sustainable Growth in the EU,* Basel, Springer International Publishing AG, 2017, pp. 105-119

Beblavý Miroslav, Lenaerts Karolien, ‘’Stabilising the European Economic and Monetary Union: What to expect from a common unemployment benefits scheme’’, *CEPS Research Report,* II (2017), pp. 1-17

Beck Hanno, Prinz Aloys, ‘’The Trilemma of a monetary union: Another impossible trinity’’, *Intereconomics,* XLVII, I (2012), pp. 39-43

Beckworth David, ‘’The Monetary Policy Origins of the Eurozone crisis’’, *Mercatus Working Paper,* Mercatus Center at George Mason University - Department of Economics, 2016, pp. 1-47

Behre Frederich, ‘’Fiscal Union – or the legally impossible task to stabilize the Euro’’, PhD Research Paper, University of Leiden, Europa Institute, 2017, pp. 1- 13

Bénassy-Quéré Agnès, Ragot Xavier, ‘’A Policy Mix for the Euro Area’’, *Conseil d’analyse économique,* XXI (2015), pp. 1-12

Bénassy-Quéré Agnès, Ragot Xavier, Guntram Wolff, ‘’Which fiscal union for the Euro-area?’’, *CAIRN – Conseil d’analyse économique,* XXIX, II (2016), pp. 1-12

Bénassy-Quére Agnès, ‘’A sovereignless currency’’, in Baldwin Richard, Giavazzi Francesco (edited by), *How to fix Europe’s monetary union*, London, CEPR Press, 2016, pp. 62-74

Bénassy-Quéré Agnès, Brunnermeier Markus, Enderlein Henrik, Farhi Emmanuel, Fratzscher Marcel, Fuest Clemens, Gourinchas Pierre-Olivier, Martin Philippe, Pisani Florence, Rey Hélène, Véron Nicolas, Weder di Mauro Beatrice, Zettelmeyer Jeromin,‘’Reconciling risk sharing with market discipline: A constructive approach to euro area reform’’, *CEPR Policy Insight,* XCI, I (2018), pp. 1-24

Benford James, Best Thomas, Joy Mark, ‘’ Sovereign GDP-linked bonds’’, *Bank of England – financial stability paper,* XXXIX, IX (2016), pp. 1-22

Blyth Mark, *The future of the Euro,* New York, Oxford University Press, 2015, pp. 1-43

Bonfim Diana, Pereira David, "GDP-linked bonds: design, effects, and way forward," *Economic Bulletin and Financial Stability Report Articles and Banco de Portugal Economic Studies, Banco de Portugal, Economics and Research Department,* (2018), pp. 15-38

Bundesverfassunggericht, Judgment of the Second Senate of 30th June 2009, 2 BvE 2/08 (*Lisbon Decision*) [2009]

Carnot Nicolas, Clemens Ulrich, Larch Martin,Vasicek Borek, ‘’The policy mix, when monetary policy is constrained at the zero lower bound (ZLB)’’, Quarterly Report on the Euro Area (QREA), DG ECOFIN, European Commission, XV, III (2016), pp. 19-28

Chari, V. V, Dovis Alessandro, Kehoe Patrick, J, ‘’Reforming the European Monetary Union’’, Economic Policy Papers, XVII, III (2017), pp. 1-6

Clayes Grégory, Darvas Zsolt, Wolff Guntram, ‘’Benefits and drawbacks of European Unemployment Insurance’’, *Bruegel Policy Brief,* VI (2014), pp. 1-8

Claeys Grégory, ‘’How should the European Central Bank normalise its monetary policy?’’, *Bruegel policy contribution,* XXXI, X (2017), pp. 1-17

Claeys Grégory, ‘’How to build a resilient monetary union? Lessons from the Eurocrisis’’, *ADBI Working Papers – Asian Development Bank Institute,* DCCLXXVIII, IX (2017), pp. 1-40

Claeys Grégory, ‘’The missing pieces of the Euro architecture’’, *Brugel Policy Contribution,* XVII, X (2017), pp. 1-23

Claeys Grégory, Demertzis Maria and Maza Jan, ‘’A monetary policy framework for the European Central Bank’’, *Bruegel Policy Contribution,* XXI, XI (2018), pp. 1-19

Cobham David, Cobham Zis, George Money, Macro and Finance Research Group, *From EMS to EMU: 1979 to 1999 and Beyond,* Cobham David and Zis George (edited by), Basingstoke, Hampshire and London, MacMillan Press LTD, 1999, pp. 43-66

Committee for the Study of Economic and Monetary Union, ‘’Report on Economic and Monetary Union in the European Community’’, European Commission, Working Document (1989), http://aei.pitt.edu/1007/, updated on the 27th May 2014, consulted on the 16th September 2018

Council and Commission of the European Communities, ‘’Report to the Council and the Commission on the realization by stages of economic and monetary union in the Community « Werner Report »’’, *Bulletin of the European Communities,* XI (1970)

Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, Official Journal, L178/5 [1988]

Council of the European Union, Statement by the heads of state or government of the Euro Area and EU institutions, [2011]

Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism, Official Journal, L 118/1 [2010]

Cózar Miguel Marín, ‘’The only feasible fiscal union for the euro area’’, European View, XVI, I (2017), pp. 23-32

Cram Laura, Dinan Desmond, Nurgent Neill, *Developments in the European Union,* New York, Palgrave Macmillan, 1999

Curtin Deirdre, ‘’Accountable Independence of the European Central Bank: Seeing the logics of Transparency’’, *European Law Journal,* XXIII, VIII (2017), pp. 28-44

Danescu Elena, ‘’The Werner Report of 1970: a blueprint for EMU in the EU?’’, Panel on ‘’Architects of the Euro’’, Miami, (2017), pp. 1-30

Darvas Zsolt, Martin Philippe, Ragot Xavier, ‘’European fiscal rules require a major overhaul’’, Bruegel policy contribution, XVIII, X (2018), pp. 1-18

De Grauwe Paul, Gros Daniel, ‘’A new two-pillar strategy for the ECB’’, *CESifo working paper,* MMXVIII (2009), pp. 1-18

De Grauwe Paul, ‘’The fragility of the Eurozone’s institution’’, *Open Economic Review,* XXI, I (2010), pp. 1-8

De Grauwe, Paul, ‘’The governance of a fragile Eurozone’’, *CEPS Working Document,* CCCXLVI , V (2011), pp. 1-28

De Grauwe Paul, ‘’Design failures in the Eurozone: can they be fixed?’’, *LEQS paper,* LVII, II (2013), pp. 1-40

De Grauwe Paul, ‘’The European Central Bank as Lender of Last Resort in the Government Bond Markets, *CESIFO Economic Studies,* LIX, III (2013), pp. 520-535

De Grauwe Paul, Ji Yuemei, ‘’How to reboot the Eurozone and ensure its long-term survival’’, in Baldwin Richard and Giavazzi Francesco (edited by) *How to fix Europe’s monetary union,* London, CEPR Press, 2016, pp. 137-147

Decision of the European Central Bank of 4 March 2004 on public access to European Central Bank documents (ECB/2004/3), Official Journal of the European Union, L 80/42 [2004]

Dedman Martin, *Development of the European Union 1945-9: A history of European Integration,* London, Routledge, 1996

Demertzis Maria, Wolff Guntram, ‘’What are the prerequisites for a euro-area fiscal capacity?’’, *Bruegel Policy Contribution,* XIV (2016), pp. 1-11

Demertzis Maria, Zenios Stavros, ‘’State contingent debt as insurance for Euro-area sovereign’’, *Bruegel Working Paper*, III (2018), pp. 1-28

Destais Christophe, ‘’Are state-contingent sovereign bonds the solution to avoid government debt crisis?’’, *Policy Brief CEPII*, XIX, XI (2017), pp. 1-16

Deutscher Bundestag, Basic Law for the Federal Republic of Germany, [2017]

Driffill John, ‘’Unconventional Monetary Policy in Eurozone’’, *Open Economic Review*, XXVII, II (2015), pp. 1-20

Dullien Sebastien, ‘’The Macroeconomic stabilisation impact of a European Basic Unemployment Insurance Scheme’’, *Intereconomics*, XLIX, IV (2017), pp. 189-193

Dullien Sebastien, Fernández Jonas, López Marc, Maass Gero, del Prado Daniel, von Weizsäcker Jakob, ‘’Fit for purpose: a German-Spanish proposal for a robust European Unemployment Insurance’’, *Working paper*, Bonn, Friedrich Ebert Stiftung, (2017)

Eichengreen Barry, ‘’The Breakup of the Euro Area’’ in Alesina Alberto and Giavazzi Francesco (edited by), *Europe and the Euro*, Chicago, University of Chicago Press, 2010, pp. 11-51

Eichengreen Barry, ‘’The Eurozone crisis: the theory of optimum currency areas bites back’’, *Notestein Academy White Paper Series*, III (2014), pp. 1-18

Eichengreen Barry, Wyplosz Charles ‘’Minimal Conditions for the survival of the euro’’ in Baldwin Richard and Giavazzi Francesco (edited by) *How to fix Europe’s monetary union,* London, CEPR Press, 2016, pp. 34-45

Eichengreen Barry, ‘’The European Central Bank: from problem to solution’’ in *The Search for Europe: Contrasting Approaches*, Madrid, BBVA, 2016, pp. 3-23

Eijffinger, Sylvester, Hoogduin, Lex, ‘’ECB: Quo vadis?’’, *Intereconomics*, LIII, III (2018), pp. 170-173

European Central Bank Banking Supervision, ‘’Guidance on non-performing-loans’’, (2017), pp. 8-12

European Central Bank, Financial integration in Europe, V (2017) pp. 10-14

European Central Bank, Updates on economic and monetary development, *Monthly Economic Bulletin*, III (2017)

European Central Bank, Economic Bulletin, Fraccaroli Nicolò, Giovannini Alessandro, Jamet, Jean-François, ‘’The evolution of the ECB’s accountability practices during the crisis’’, V (2018)

European Commission, ‘’Final communication from the Commission to the European Parliament and the Council strengthening the social dimension of the Economic and Monetary Union’’, COM(2013) 690 [2013]

European Commission, ‘’One Currency for one Europe: The road to Euro’’, Luxembourg, Publications office of the European Union, 2015

European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, COM(2015) 586 final [2015]

European Commission, ‘’The Macroeconomic Imbalance Procedure: Rationale, Process, Application: A Compendium’’, *Institutional Paper*, XXXIX (2016)

European Commission, ‘’Proposal for a Council Regulation on the establishment of the European Monetary Fund’’, COM(2017) 827 final [2017]

European Commission, ‘’Reflection on the Deepening of the Economic Monetary Union’’, COM (2017) 291 [2017]

European Commission, ‘’White Paper on the Future of Europe, Reflections and Scenarios for the EU27 by 2025’’, COM(2017)2025 [2017], pp. 1-32

European Council, ‘’Solemn Declaration of the European Union’’, *Bulletin of the European Communities,* VI [1983]

European Court of Justice, *Meroni vs. High Authority*, Case 9/56, [1958]

European Court of Justice, *Commission vs. United Kingdom*, C- 804/79, [1981]

European Court of Justice, *Opinion pursuant to Article 228(6) of the EC Treaty*, Opinion 2/94, [1996]

European Court of Justice, *Portugal vs. Council*, C-149/96, [1999]

European Court of Justice, *British American Tobacco (Investments) and Imperial Tobacco*, C-491/01, [2002]

European Court of Justice, *Parliament vs. Council*, C-166/07, [2009]

European Court of Justice, *Thomas Pringle v Government of Ireland and Others*, C-370/12, [2012]

European Court of Justice, *Weiss and others*, C-493/17, [2018]

European Parliament, European Council, Regulation (EU) No 1176/2011 of the European Parliament and the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, Official Journal L 306/25 [2011]

European Parliament, European Council, Regulation (EU) No 1304/2013 of the European Parliament and of the Council of 17 December 2013 on the European Social Fund and repealing Council Regulation (EC) No 1081/2006, Official Journal L 347/470 [2013]

European Parliament, European Council, Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, Official Journal L225/1 [2014]

European Union, Consolidated version of the Treaty on European Union, Official Journal, C326/13 [2012]

European Union, Consolidated version of the Treaty on the Functioning of the European Union, Official Journal, C326/47 [2012]

European Union, Treaty establishing the European Economic Community, [1957]

Flassbeck Heiner, Spiecker Friederike, ‘’The Euro – A story of Misunderstanding’’, *Intereconomics,* XLVI, IV (2011), pp. 180-187

Frankel Jeffrey, ‘’No Single Currency Regime is Right for All Countries or At All Times’’, *NBER Working Paper*, VIICCCXXXIX (1999), pp. 1-41

Frankel Jeffrey, ‘’Causes of Eurozone crisis’’, in Baldwin Richard, Giavazzi, Francesco (edited by), *The Eurozone Crisis: A consensus view of the causes and a Few Possible remedies*, London, CEPR Press, 2016, pp. 109-120

Frankel Jeffrey, Barkbu Bergljiot, Blavy Rodolphe, Oman William, Schoelemann Hanni, ‘’Economic Convergence in the Euro Area: Coming together or drifting apart?’’, *IMF Working paper*, XVIII, X (2018), pp. 1-47

Gaynor K.B, Karakitsos Elia, *Economic Convergence in a Multispeed Europe*, Houndmills, Basingstonke, Hampshire and London, Macmillan Press LTD, 1997

Gross Daniel, ‘’The Eurozone Crisis and foreign debt’’ in Baldwin Richard, Giavazzi Francesco (edited by*), The Eurozone Crisis: A consensus view of the causes and a few possible remedies*, London, CEPR Press, 2015, pp. 121-128

Gros Daniel, ‘’Completing the Banking Union’’, in Baldwin Richard, Giavazzi Francesco (edited by), *How to Fix Europe's monetary union,* London, CEPR Press, 2016, pp. 87-98

Gros Daniel, Mayer Thomas, ‘’A European Monetary Fund : Why and How?’’, *CEPS Working Document*, XI (2017), pp. 1-18

Hall Peter, ‘’The Euro crisis and the future of the European Integration’’ in Acemoglu Daron (edited by), *The Search of Europe: Contrasting approaches*, Madrid, BBVA, 2016, pp. 46-67

Hamburg Institute of International Economics (HWWA), ‘’French Franc devaluation: A first step towards realignment?’’, *Intereconomics*, IV, IX (1969), pp. 268-269

Hodson Desmond, ‘’Policy Making under Economic and Monetary Union: Crisis, Change and Continuity’’ in Wallace Hellence, Pollack Mark, Young Alasdair (edited by), *Policy-Making in the European Union*, Oxford, Oxford Press, 2015, pp. 166-195

Hoffman-Axthelm Leo, ‘’Institutional Loneliness: how to fix conflicts of interest at the ECB’’, in Ryan John and Hoffman-Axthelm Leo (edited by), *The Future of the European Central Bank, LSE Ideas*, VI (2018), pp. 10-17

IMF World Economic Outlook (WEO), *Uneven Growth Short- and Long-Term Factors, World Economic and Financial Surveys*, Conventional Paper, Washington, 2018

IMF World Economic Outlook (WEO), *World Economic and Financial Survey*, Occasional paper, 2018

IMF, ‘’State-contingent debt instrument for sovereign’’, *IMF Policy Paper*, (2017), pp. 1-46

Jager Jennifer, Hafner Kurt, ‘’The Optimum Currency Area Theory and the EMU’’, *Intereconomics*, XLVIII, V (2013), pp. 315-322

James Harold, *Making the European Monetary Union*, Cambridge, Massachusetts, London, The Belknap Press of Harvard University, 2012

Jenkins Roy, ‘’Europe's present challenge and future opportunity’’, First Jean Monnet Lecture, European University Institute, Florence, (1977), pp. 1-17

Juncker Jean-Claude, ‘’A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change’’, Opening Statement in the European Parliament Session, European Commission, (2014), pp. 1-37

Juncker Jean-Claude, Tusk Donald, Dijsselbloem Jeroen, Draghi Mario and Schulz Martin, ''The five President's report: completing Europe's economic and monetary union'', European Commission, Background documents on economic and monetary union'', (2015), pp. 1-24

Karamichailidou Giannoula, Margaritis Dimitris, Mayes David, ''Asymmetry, Austerity and Anxiety: The approach to the Greek Debt Crisis'' in Floros Christos, Chatziantonious Ioannis (edited by), *The Greek Debt Crisis: In Quest of Growth in Times of Austerity,* Cham, Palgrave Mcmillan, 2017, pp. 37-83

Karras Georgios, ''How homogenizing are monetary unions? Evidence from the U.S. states'', *North American Journal of Economics and Finance*, XIV, III (2003), pp. 381-397

Maes Ivo, ''On the Origins of the Franco-German EMU controversies'', *European Journal of Law and Economics,* XVII, I (2004), pp. 21-39

Makoff Gregory, ''GDP-indexed Bonds: A way forward'', *Policy Brief Centre for International Governance Innovation,* XCVII (2017), pp. 1-11

Marrelli Enrico, Signorelli Marcelli, ''Convergence, Crisis and unemployment in Europe: The need for innovative policies'', *Croatian Economic Survey,* XVII, II (2017), pp. 5-56

Marsh David, *The Battle for the New Global Currency,* New Haven and London, Yale University Press, 2009

Martin Feldstein, ''The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability'', *The Journal of Economic Perspectives,* XI, IV (1997), pp. 23-42

Martinez-Garcia Enrique, Grossman Valerie, ''Consequences of the Euro: Monetary Union, Economic Disunion?'', *Economic Letter – Dallas Fed,* XXII, II (2016), pp. 1-4

Matsaganis Manos, Leventi Chrysa, Flevotomou Maria, ''The crisis and tax evasion in Greece: what are the distributional implications?'', *Cesifo Forum,* XIII, II (2012), pp. 26-32

McCormick John, *Understanding the European Union,* Hampshire, MacMillan Distribution, 1999

McKinnon Ronald, ''Optimum Currency Areas'', *The American Economic Review,* LII, IV (1963), pp. 717-725

Micossi Stefano, ''The Monetary Policy of the European Central Bank (2002-2015)'', *CEPS Special Report,* CIX, V (2015), pp. 1-37

Micossi Stefano, ''What future for the Eurozone?'', *Luiss School of European Political Economy Brief,* VIII (2015), pp. 1-11

Micossi Stefano, ''A blueprint for completing the banking union'', *CEPS Policy Insight,* XLII, XI (2017), pp. 1-20

Ministro dell'Economia e delle Finanze, ''European Unemployment Insurance Scheme'', *working paper,* X (2015), pp. 1-4

Ministry of Justice, Finland, The Constitution of Finland, [2011]

Monacelli Tommaso, ''Asymmetries and Eurozone policy-making'' in Baldwin Richard and Giavazzi Francesco (edited by), *How to fix Europe's monetary union, views of leading economists*, CEPR Press, London, 2016, pp. 160-175

Mongelli Francesco, ‘’European economic and monetary integration and the optimum currency area theory’’, *Economic Papers*, CCCII , II (2008), pp. 1-58

Mundell Robert, ‘’A Theory of Optimum Currency Areas’’, *The American Economic Review*, LI, IV (1961), pp. 657-665

Noble Charles, *Examining Eurozone Divergence*, bachelor thesis, University of Puget Sound - Economics Department of Economics Theses, Year 2011-2012, sup. K. Stirling

Odor Ludovit, ‘’The Good, the Bad and the Ugly: Strengths and Weaknesses of the new European Fiscal Framework’’, *Discussion Papers from Council for Budget Responsibility*, III (2014), pp. 523-556

Office for Official Publications of the European Communities, Protocol on the Transition to the Third Stage of Economic and Monetary Union, Official Journal, C 191 [1992]

Paleta Tomas, ‘’Maastricht Criteria of... Divergence?’’, *Review of economic perspectives*, XII, II (2012), pp. 92-119

Pavlidis George, ‘’Designing a Sovereign Debt Restructuring Mechanism for a European Monetary Fund’’, *Intereconomics* LIII, IV (2018), pp. 221-224

Pissarides Christopher, ‘’Rebooting Europe: Closer Fiscal cooperation needed’’ in *How to fix Europe’s monetary union*, London, CEPR Press, 2016, pp. 133-136

Protocol 4, Consolidated version of the Treaty on the Functioning of the European Union, Official journal, C326 [2012]

Reinert Kenneth, *An introduction to international economics. New perspectives on the world economics*, New York, Cambridge University Press, 2011

Repasi René, ‘’Legal Options and Limits for the Establishment of a European Unemployment Benefit Scheme’’, *CEPS research project,*, I (2017), pp. 1-64

Ruscakova Anna, Semancikova Jozefina ‘’The European debt crisis: a brief discussion of its causes and possible solutions’’, *Procedia – Social and Behavioral Sciences*, CCXX, (2016), pp. 399-406

Ryan John, ‘’Forgotten Lessons for the Eurozone’’, *European Policy Brief*, XLIII, V (2016), pp. 1-10

Ryan John, ‘’Is the European Central Bank too big to succeed?’’ in Ryan John and Hoffman-Axthelm Leo (edited by), *The Future of the European Central Bank*, LSE Ideas, VI (2018), pp. 3-8

Sapir André, Wolff Guntram, ‘’Euro-Area Governance: What to reform and how to do it’’, *Bruegel Policy Brief*, I (2015), pp. 1-8

Sapir Andrea, ‘’The Eurozone needs less heterogeneity’’, in R. Baldwin, F. Giavazzi (edited by) *How to fix Europe’s monetary union*, London, CEPR Press, 2016, pp. 179-187

Sapir Andrea, Schoenmaker Dirk, ‘’The time is right for a European Monetary Fund’’, *Bruegel Policy Brief*, IV, X (2017), pp. 1-8

Sapir Andrea, Véron Nicolas, Wolff Guntram,‘’Making a reality of Europe’s Wolff’’, *Bruegel Policy Contribution*, VII, V (2018), pp. 1-13

Schütze Robert, *The European Union law*, Cambridge, Cambridge University Press, 2015

Sheridan Jerome, ‘’The consequences of the Euro’’, *Challenge*, XLII, I (1994), pp. 43-54

Single European Act, Official Journal of the European Communities, L 169/1 [1987]

Stiglizt Joseph, *The Euro: How a Common Currency Threatens the Future of Europe,* New York, Norton & Co Inc., 2016

Tabellini Guido, ‘’Building common fiscal policy in the Eurozone’’, in Baldwin Richard and Giavazzi Francescobbb (edited by), *How to fix Europe’s monetary union: views of leading economist,* London, CEPR Press, 2016, pp. 120-130

Tache, I, Danu, A. L, ‘’Comparison between the European Central Bank as a new monetary experiment and other major central banks - US Federal Reserve and Bank of Japan’’, *Bulletin of the Transilvania University of Brasov,* VII, V (2014), pp. 295-302

Team Eurozone 2020, ‘’Future Scenario for the Eurozone: 15 Perspective on the Euro Crisis’’, *International Policy Analysis Friedrich Ebert Stiftung,* III (2013), pp. 1-9

Thirion Gilles, ‘’European Fiscal Union: Economic rationale and design challenges’’, *CEPS working document,* I (2017), pp. 1-34

Tietmeyer Hans, ‘’From the Werner Report to the Euro’’, Pierre Werner Lecture, Luxembourg, (2003), pp. 1-30

Tooze Adam, *Crashed: How a decade of a financial crisis changed the world*, New York, Viking, 2018, pp. 330-456

Van Ark Bart, ‘’Contrasts in Europe’s investment and productivity performance’’, in Acemoglu Daron (edited by), *The Search for Europe: Contrasting approaches*, BBVA, Madrid, 2016, pp. 1-19

Véron Nicolas, *Europe’s Radical Banking Union,* Brussels, Bruegel Essay and Lecture Series, (2015), pp.7-13

Véron Nicolas, Wolff Guntram, ‘’Capital Markets Union: A vision for the long-term’’, Bruegel Policy Contribution, V (2015), pp. 1-18

Wren-Lewis Simon, ‘’The Eurozone’s flaws are not intrinsic’’, *Intereconomics,* LI, I (2016), pp. 20-24

Wyplosz Charles, ‘’EMU: Why and How it might happen’’, *Journal of Economic Perspectives,* XI, IV (1997), pp. 3-21

Wyplosz Charles, ‘’The six flaws of the Eurozone, *Economic Policy,* XXXI, LXXXVII (2016), pp. 559-606

Yilmaz Derya, ‘’Unconventional Monetary Policies in the Eurozone: Considering Theoretical Background and Policy Outcomes’’, *Business and Economics Research Journal,* VI, III (2015), pp. 51-68

Young Brigitte, Semmler Willi, ‘’The European Sovreign Debt Crisis: Is Germany to Blame?’’, *German Politics and Society,* XXIX, XCVII (2011), pp. 1-24

Zeppernick Ralf, ‘’Effects of the Euro on Trade, Capital Markets and the International Monetary System’’, *Intereconomics,* XXXIII, VI (1999), pp. 279-285

Zettelmeyer Jeronim, Avgouleas Emilios, Eichengreen Barry, Maduro Miguel, Panizza Ugo, Portes Richard, Weder di Mauro Beatrice, Wyplosz, Charles, ‘’How to solve the Greek Debt Problem’’, *Peterson Institute for International Economics – Policy Brief,* XVIII, X (2018), pp. 1-12

WEBSITES

Bank of Japan, Kuroda Haruiko, ‘’The Practice and Theory of Unconventional Monetary Policy’’,https://www.boj.or.jp/en/announcements/press/koen_2014/data/ko140608a1.pdf, updated on the 7th June 2014, consulted on the 20th October 2018

Banque de France, EcoNotepad, Cabrillac Bruno, Gauvin Ludovic, Gossé Jean-Baptiste and Lalanne Florian, ‘’GDP-indexed bonds: a solution to debt crises?’’, https://blocnotesdeleco.banque-france.fr/en/blog-entry/gdp-indexed-bonds-solution-debt-crises, published on the 19th April 2018, consulted on the 7th December 2018

Brookings, Bernake Ben, ‘’Temporary price-level targeting: An alternative framework for monetary policy’’, https://www.brookings.edu/blog/ben-bernanke/2017/10/12/temporary-price-level-targeting-an-alternative-framework-for-monetary-policy/, published on the 12th October 2017, consulted on the 6th January 2019.

Bruegel, Andritzky Jochen, ‘’Enhacing the ESM lending toolkit through a precautionary credit line’’, http://bruegel.org/2018/06/enhancing-the-esm-lending-toolkit-through-a-precautionary-credit-line/, published on the 11th June 2018, consulted on the 15th November 2018

Bruegel, Darvas Zslot, Martin Philippe, Ragot Xavier, ‘’The economic case for an expenditure rule in Europe’’, http://bruegel.org/2018/09/the-economic-case-for-an-expenditure-rule-in-europe/, published on the 13th September 2018, consulted on the 20th November 2018

Bruegel, Demertzis Maria, ‘’Raising the inflation target: a question of robustness’’, http://bruegel.org/2017/06/raising-the-inflation-target-a-question-of-robustness/, published on the 22nd June 2017, consulted on the 1st December 2018

Bruegel, Schnaebel Isabel, Veron Nicholas, ‘’Breaking the Stalemate on European Deposit Insurance, Bruegel, http://bruegel.org/2018/03/breaking-the-stalemate-on-european-deposit-insurance/, published on the 5th March 2018, consulted on the 9th December 2018.

Bruegel, Schoenmaker Dirk, Wolff Guntram, ‘’What options for European deposit insurance?’’, http://bruegel.org/2015/10/what-options-for-european-deposit-insurance/ , published on the 8th October 2018, consulted on the 22nd November 2018

Corporate Europe Observatory, ‘’Corporate capture at its most extreme: 98% of ECB advisors represent industry’’, https://corporateeurope.org/pressreleases/2017/10/corporate-capture-its-most-extreme-98-ecb-advisors-represent-industry, published on the 3rd October 2017, consulted on the 30th November 2018

CVCE, ‘’Economists v. monetarists — agreements and clashes in the drafting of the Werner Report’’, https://www.cvce.eu/content/publication/2012/4/3/875a85f1-e099-4013-acbf-68b2c50a6879/publishable_en.pdf, consulted on the 16th September 2018

CVCE, ‘’Exposé de Pierre Werner sur l'Union économique et monétaire en tant qu'étape vers l'Europe politique’’ (Davos, 28 janvier 1972), https://www.cvce.eu/content/publication/2010/10/25/b0377149-9870-48ea-bca3-f1793ec80f87/publishable_fr.pdf, consulted on the 1st January 2019

CVCE, ‘’Final communiqué of the Hague Summit (2 December 1969)’’, https://www.cvce.eu/content/publication/1997/10/13/33078789-8030-49c8-b4e0-15d053834507/publishable_en.pdf, consulted on the 16th September 2018

CVCE, ‘’Rapport intérimaire au Conseil et à la Commission concernant la réalisation par étapes de l'Union économique et monétaire (Luxembourg, 20 mai 1970)’’,

https://www.cvce.eu/obj/interim_report_to_the_council_and_the_commission_on_the_achievement_by_stages_of_economic_and_monetary_union_luxembourg_20_may_1970-en-fd977fc3-548f-42df-b79a-628d952633ae.html, consulted on the 16th September 2018.

CVCE, ''The emergence of a plan for an economic and monetary union'', https://www.cvce.eu/en/education/unit-content/-/unit/d1cfaf4d-8b5c-4334-ac1d-0438f4a0d617/542a8508-f911-4c0f-9d3c-11b27ab43ef3, consulted on the 16th September 2018.

CVCE, ''The first and second Barre Plan, https://www.cvce.eu/obj/the_first_and_second_barre_plans-en-a27c0587-77ad-479e-a644-cb56dbaf9c90.html'', consulted on the 16th September 2018

Eur-Lex Access to the European Union Law, ''Opting-out'', https://eur-lex.europa.eu/summary/glossary/opting_out.html, consulted on the 16th September 2018

European Banking Authority (EBA), ''Deposit Guarantee Schemes data'', https://eba.europa.eu/regulation-and-policy/recovery-and-resolution/deposit-guarantee-schemes-data, consulted on the 9th December 2018

European Central Bank - Statistical Data Warehouse, ''Government debt (consolidated) (as % of GDP)'', http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=325.GFS.Q.N.I8.W0.S13.S1.C.L.LE.GD.T._Z.XDC_R_B1GQ_CY._T.F.V.N._T, consulted on the 17th October 2018

European Central Bank (ECB), ''Monthly Bulletin June 2010'', https://www.ecb.europa.eu/pub/pdf/other/mb201006_focus01.en.pdf?19bf37eb4c6d5fac0955948ca5af3aa0, consulted on the 21st October 2018

European Central Bank (ECB), ''Letter from the ECB President to several MEPs on ECB's interactions with external parties, Frankfurt am Main, 23 January 2018 L/MD/18/21'', https://www.ecb.europa.eu/pub/pdf/other/ecb.mepletter180123_s_d_meps.en.pdf?d48b2fb5f260b36bb72a8812753e1e28, consulted on the 30th November 2018

European Central Bank Banking Supervision, ''Risk Assessment'', https://www.bankingsupervision.europa.eu/banking/priorities/risk_assessment/html/index.en.html, consulted on the 14th November 2018

European Central Bank Statistical Data Warehouse, ''Inflation Rate (HICP)'', http://sdw.ecb.europa.eu/home.do, consulted on the 18th October 2018.

European Central Bank, ''Scope of monetary policy'', https://www.ecb.europa.eu/mopo/intro/role/html/index.en.html, consulted on the 9th December 2018

European Central Bank, ''The European Monetary Institute (1994-98)'', https://www.ecb.europa.eu/ecb/access_to_documents/archives/emi/html/index.en.html, consulted on the 16th September 2018

European Central Bank, Mersch Yves, Member of the Executive Board of the ECB, ''Financial stability and the ECB'', ESCB Legal Conference, Frankfurt, 6 September 2018, https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180906.en.html, consulted on the 23rd December 2018

European Central Bank, Statistical Warehouse, ''Parameters and Transformation of the Unemployment in the Eurozone from 1999 to 2018'', http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=132.STS.M.I8.S.UNEH.RTT000.4.000, consulted on the 17th October 2018

European Commission Press Release Database, ''Juncker Jean-Claude, State of Union Address 2017, held in Brussel on the 13th September 2017'', http://europa.eu/rapid/press-release_SPEECH-17-3165_en.htm, consulted on the 16th November 2018

European Commission Eurobarometer Interactive, ''Trust in the European Central Bank'', http://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/Chart/getChart/themeKy/9/groupKy/27, consulted on the 29th November 2018.

European Commission Eurobarometer Interactive, ''Trust in the European Union'', ,https://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/Chart/index, consulted on the 10th October 2018

European Commission Press Release, ''Cross-Border Payments'', http://europa.eu/rapid/press-release_MEMO-18-2424_en.htm, consulted on the 28th March 2018, consulted on the 16th November 2018

European Commission, ''ERM II – the EU's Exchange Rate System'', https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/introducing-euro/adoption-fixed-euro-conversion-rate/erm-ii-eus-exchange-rate-mechanism_en, consulted on the 16th September 2018

European Commission, ''European Deposit Insurance Scheme'', https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/european-deposit-insurance-scheme_en, consulted on the 15th November 2015

European Commission, ''Single resolution mechanism'', https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/single-resolution-mechanism_en, consulted on the 14th November 2018

European Neighbourhood Policy And Enlargement Negotiations, ''Accession Agreements'', https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/accession-criteria_en, updated on the 6th December 2016, consulted on the 16th September 2018

European Neighbourhood Policy And Enlargement Negotiations, ''Association Agreements'', https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/association-agreement_en, updated on the 6th December 2016, consulted on the 16th September 2018

European Parliament, ''Fact Sheets on the European Union – Free Movement of Capital'', http://www.europarl.europa.eu/factsheets/en/sheet/39/free-movement-of-capital#_ftn3, updated in May 2018, consulted on the 16th September 2018

European Stability Mechanism (ESM), ''Before the ESM: EFSF – the temporary fiscal drop'', https://www.esm.europa.eu/efsf-overview, consulted on the 20th October 2018

European Stability Mechanism, Klaus Regling, ESM Managing Director,
"A European Monetary Fund: for what purpose?", Euro 50 Group conference
Brussels, 10 April 2018, https://www.esm.europa.eu/speeches-and-presentations/european-monetary-fund-what-purpose-speech-klaus-regling, consulted on the 11th December 2018

European Union, ''The 28 member countries of the EU'', https://europa.eu/european-union/about-eu/countries_en#tab-0-1, updated on the 2nd July 2018, consulted on the 16th September 2018

Europedia, ''Towards a political union in Europe'',
http://www.europedia.moussis.eu/books/Book_2/3/8/?all=1, consulted on the 16th September 2016

Federal Deposit Insurance Corporation (FDIC), https://www.fdic.gov/about/learn/symbol/index.html, updated on the 5th March 2017, consulted on 22nd November 2018

Federal Reserve, ''Is the Federal Reserve accountable to anyone?'', https://www.federalreserve.gov/faqs/about_12798.htm, updated on 1st March 2017, consulted on the 18th November 2018

Financial Times, ''Five reforms the ECB should embrace'', https://ftalphaville.ft.com/2018/10/15/1539576001000/Five-reforms-the-ECB-should-embrace/, published on the 15th October 2018, published on the 29th November 2018.

Financial Times, Barber Tony, ''Greece finance minister reveals plan to end debt stand-off'', https://www.ft.com/content/7af4252c-ab03-11e4-91d2-00144feab7de, published on the 2nd February 2015, consulted on the 7th December 2018

Fondation Robert Schuman, ''Declaration of 9th May 1950 delivered by Robert Schuman'', *European Issue*, 10th May 2011, p.1, https://www.robert-schuman.eu/en/doc/questions-d-europe/qe-204-en.pdf, consulted on the 22th September 2018

Global Financial Integrity, Kar Dev, ''Asymmetric Shocks and other woes of the Eurozone'', https://www.gfintegrity.org/asymmetric-shocks-and-other-woes-of-the-eurozone/, published on the 20th June 2011, consulted on the 18th October 2018

Independent, ''Who is responsible for the eurozone crisis? The simple answer: Germany, Simon Wren-Lewis'', https://www.independent.co.uk/voices/who-is-responsible-for-the-eurozone-crisis-the-simple-answer-germany-a6771536.html, published on the 13th December 2015, consulted on the 20th January 2019

International Monetary Fund (IMF), ''DataMapper World Economic Outlook'', https://www.imf.org/external/datamapper/datasets/WEO, updated in April 2018, consulted on the 22th September 2018

International Monetary Fund (IMF), ''The end of the Bretton Woods System (1972–81)'', https://www.imf.org/external/about/histend.htm, consulted on the 20th January 2019

Investopedia, ''Bretton Woods Agreement'', https://www.investopedia.com/terms/b/brettonwoodsagreement.asp, consulted on the 16th September 2018

Investopedia, ''European Currency Unit (ECU)'', https://www.investopedia.com/terms/e/european-currency-unit.asp, consulted on the 16th September 2018

Investopedia, ''Golden Rule'', https://www.investopedia.com/terms/g/golden-rule.asp, consulted on the 16th September 2018

Investopedia, ''Subprime meltdown'', https://www.investopedia.com/terms/s/subprime-meltdown.asp;

Investopedia, ''The collapse of Lehman Brothers'', https://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp, both consulted on the 22nd October 2018

Social Europe, Papadimoulis Dimitris, ''The Stability And Growth Pact Has Failed'', https://www.socialeurope.eu/stability-growth-pact-failed , published on the 7th November 2016, consulted on the 20th November 2018

Social Europe, Wyplosz Charles, ''What you ought to know about the ECB and Unemployment'', https://www.socialeurope.eu/ecb, published on the 18th February 2014, consulted on the 30th November 2018

Statista, ‘’Unemployment rate in member states of the European Union in June 2018 (seasonally adjusted)’’, https://www.statista.com/statistics/268830/unemployment-rate-in-eu-countries/ both consulted on the 11th October 2018

Statista, ‘’Youth unemployment rate in Europe (EU member states) as of May 2018 (seasonally adjusted)’’, https://www.statista.com/statistics/266228/youth-unemployment-rate-in-eu-countries/

The National Archives, ‘’The 1967 devaluation of the pound’’, http://www.nationalarchives.gov.uk/cabinet-office-100/the-1967-devaluation-of-the-pound/

The New York Times, Carassava Anthee, ‘’Greece Admits Faking Data to Join Europe’’, https://www.nytimes.com/2004/09/23/world/europe/greece-admits-faking-data-to-join-europe.html, consulted on the 21st October 2018

The New York Times, Krugman Paul, ‘’Can Europe be saved?’’, https://www.nytimes.com/2011/01/16/magazine/16Europe-t.html, published on the 12th January 2011, consulted on the 9th December 2018

Trading Economics, ‘’A comparison of Spanish and Irish House Prices’’, https://tradingeconomics.com/spain/housing-index, consulted on the 18th October 2018

Trading Economics, ‘’EU GDP Growth Rate’’, https://tradingeconomics.com/euro-area/gdp-growth, consulted on the 17th October 2018

Trading Economics, ‘’Euro Area Central Bank Balance Sheet’’, https://tradingeconomics.com/euro-area/central-bank-balance-sheet, consulted on the 20th October 2018

Trading economics, ‘’Euro Area Economic Indicators’’, https://tradingeconomics.com/euro-area/indicators, consulted on the 19th December 2018

Trading Economics, ‘’Euro Area Interest Rate’’, https://tradingeconomics.com/euro-area/interest-rate, consulted on the 18th October 2018

Trading Economics, ‘’Euro Area Interest Rate’’, https://tradingeconomics.com/euro-area/interest-rate, consulter on the 18th October 2018

Trading Economics, ‘’Euro-Area Capital Flows’’, https://tradingeconomics.com/euro-area/capital-flows, consulted on the 8th October 2018

Trading Economics, ‘’Greece Capital Flows 2000-2018’’, https://tradingeconomics.com/greece/capital-flows, consulted on the 17th October 2018

Trading Economics, ‘’Greece Government Debt to GDP 2001-2018’’, https://tradingeconomics.com/greece/government-debt-to-gdp , consulted on the 18th October 2018

Trading economics, ‘’Greece Government Debt to GDP’’, https://tradingeconomics.com/greece/government-debt-to-gdp , consulted on the 20th October 2018

Trading Economics, ‘’Growth Unemployment Rate 2001-2018’’, https://tradingeconomics.com/greece/unemployment-rate, consulted on the 18th October 2018

Trading economics, ‘’Spain Economic Indicators’’, https://tradingeconomics.com/spain/indicators, consulted on the 20th October 2018

Trading Economics, ‘’Youth Unemployment Rate’’, https://tradingeconomics.com/euro-area/youth-unemployment-rate, consulted on the 17th October 2018

Trading Economics, ‘’A comparison between Spanish and Irish GDP Annual Growth Rate’’, https://tradingeconomics.com/ireland/gdp-growth-annual, consulted on the 2nd February 2018

Trading Economics, ‘’A comparison between Spanish and Irish Government Debt to GDP’’, https://tradingeconomics.com/ireland/government-debt-to-gdp, consulted on the 2nd February 2018

Trading Economics, ‘’A comparison between Spanish and Irish Unemployment rate’’, https://tradingeconomics.com/ireland/unemployment-rate, consulted on the 2nd February 2018

Vox CEPR Policy Portal, Acalin Julien, ‘’Turning national growth-indexed bonds into European Assets: A proposal to strengthen the Euro-area’’, https://voxeu.org/article/turning-national-growth-indexed-bonds-european-assets, published on the 10th October 2018, consulted on the 5th December 2018

Vox CEPR Policy Portal, Andritzky Jochen, Feld Lars, Schmidt Christoph, Schnaebel Isabel, Wieland Volker, ‘’Creditor participation clauses: Making orderly sovereign debt restructuring feasible in the Eurozone’’, https://voxeu.org/article/mechanism-proposal-eurozone-sovereign-debt-restructuring, published on the 21st July 2016, consulted on the 21st November 2018

Vox CEPR Policy Portal, Ball Laurence, ‘’The case for 4% inflation’’, https://voxeu.org/article/case-4-inflation, published on the 24th May 2013, consulted on the 1st December 2018

Vox CEPR Policy Portal, Cabrillac Bruno, Gauvin Ludovic, Gossé Jean-Baptiste, ‘’Benefits of GDP-indexed bonds for issuing countries, investors and international financial stability’’, https://voxeu.org/article/benefits-gdp-indexed-bonds, published on the 7th March 2017, consulted on the 5th December 2018

Vox CEPR Policy Portal, Corsetti Giancarlo, Dedola Luca, Jarocinski Marek, Mackowiak Bartosz, Schmidt Sebastian, ‘’Business cycle stabilisation in the Eurozone: ways forward’’, https://voxeu.org/article/business-cycle-stabilisation-eurozone, published on the 23rd October 2017, consulted on the 21st November 2018

Vox CEPR Policy Portal, Debrun Xavier, Eyraud Luc, Hodge Andrew, Lledo Victor, Pattillo Catherine, ‘’Second-generation fiscal rules: From stupid to too smart’’, https://voxeu.org/article/second-generation-fiscal-rules-stupid-too-smart?utm_source=GDPR&utm_campaign=e693d7b482-EMAIL_CAMPAIGN_2018_09_14_09_34&utm_medium=email&utm_term=0_7c51e322b7-e693d7b482-278644353, published on the 22nd May 2018, consulted on the 21st November 2018

Vox CEPR Policy Portal, Eichengreen Barry, ‘’The Euro: love it or leave it?’’, VOX CEPR Policy Portal, https://voxeu.org/article/eurozone-breakup-would-trigger-mother-all-financial-crises, consulted on the 20th January 2019

Vox CEPR Policy Portal, Feld Lars, Schmidt Christoph, Schnaebel Isabel, Wieland Volker, ’’Refocusing the European fiscal framework’’, https://voxeu.org/article/refocusing-european-fiscal-framework?utm_source=GDPR&utm_campaign=e693d7b482-EMAIL_CAMPAIGN_2018_09_14_09_34&utm_medium=email&utm_term=0_7c51e322b7-e693d7b482-278644353 , published on the 12th September 2018, consulted on the 21st November 2018

Vox CEPR Policy Portal, Gross Daniel, ‘’Eurobonds: Wrong solution for legal, political and economic reasons’’, Vox CEPR Policy Portal, https://voxeu.org/article/eurobonds-are-wrong-solution, published on the 24th August 2011, consulted on the 5th December 2018

Vox CEPR Policy Portal, Schoenmaker Dirk, ‘’Building a stable European Deposit Insurance Scheme’’, https://voxeu.org/article/building-stable-european-deposit-insurance-scheme, published on the 17th April 2018, consulted on the 22nd November 2018

Vox CEPR Policy Portal, Shiller Robert, Ostry Jonathan, Benford James, Joy Mark, ‘’Sovereign GDP-linked bonds: Rationale and design’’, Vox CEPR Policy Portal, https://voxeu.org/article/sovereign-gdp-linked-bonds-rationale-and-design, published on the 16th March 2018, consulted on the 5th December 2018

Vox CEPR Policy Portal, Tabellini Guido, ‘’Reforming the Eurozone: structuring versus restructuring sovereign debts’’, Vox CEPR policy portal, https://voxeu.org/article/structuring-versus-restructuring-sovereign-debts-eurozone, published on the 23rd November 2017, published on the 4th December 2018

Vox CEPR Policy Portal, Teulings Coen, ‘’The EU’s fiscal rules urgently need a revision’’, https://voxeu.org/article/eu-s-fiscal-rules-urgently-need-revision?utm_source=GDPR&utm_campaign=e693d7b482-EMAIL_CAMPAIGN_2018_09_14_09_34&utm_medium=email&utm_term=0_7c51e322b7-e693d7b482-278644353, published on the 13th September 2018, consulted on the 20th November 2018

Vox CEPR Policy Portal, Valiante Diego, ‘’Europe’s untapped capital market’’, Vox CEPR Policy Portal, https://voxeu.org/article/capital-market-union-europe , published on 13th March 2016, consulted on the 28th November 2018

Vox CEPR Policy Portal, Xafa, Miranda, ‘’Where we stand on European Capital Markets Union’’, Vox CEPR Policy Portal, https://voxeu.org/article/where-we-stand-european-capital-markets-union, published on the 17th April 2018, consulted on the 28th November 2018

Youtube, ‘’Draghi says the euro is irreversible’’, https://www.youtube.com/watch?v=wuSoD2BcPFY, consulted on the 13th November 2018

Youtube, ‘’Global Investment Conference - Mario Draghi, President of the European Central Bank’’, 26th July 2012, https://www.youtube.com/watch?v=hMBI50FXDps&t=458s, consulted on the 18th October 2018