

Marek Dabrowski
CASE Fellow
CASE – Center for Social and Economic Research
e-mail: Marek.Dabrowski@case-research.eu

Version of June 4, 2012
Work in progress
Comments welcomed

Fiscal and Monetary Policy Determinants of the Eurozone Crisis and its Resolution

[Paper to be presented at the 9th Euroframe Conference on Economic Policy Issues in the European Union on *The euro area in crisis: challenges for monetary and fiscal policies, and prospects for monetary union*, Kiel, June 8, 2012]¹

1. Introduction

At the end of 2010 the world economy entered the new phase of macroeconomic and financial turbulences caused, this time, by large fiscal imbalances in several developed countries. Unlike in 2007-2008 when crisis started in the US financial sector² this time the EU, especially the so-called peripheral countries of the Economic and Monetary Union (EMU) has become most heavily affected. As result, since the end of 2011 several EU economies entered either stagnation or shallow recession. The crisis is far from being resolved with the potential to deepen and spill over dramatically through the entire world economy if the worst-case scenario (i.e., disintegration of the Eurozone) materializes.

Unfortunately, the public discussion on both causes of the crisis and potential remedies is sometimes misleading and overdramatizes policy choices what does not help in taking right decisions. It is often driven by short-term interests of financial market participants who want to minimize their potential loses and look for another generous bailout at the expense of taxpayers, media hunt for breaking news, and politicians wanting to avoid political costs of adopting painful corrective measures.

As the crisis is currently centered on the Eurozone the reforms shall also involve some changes in the EU/EMU institutional design, including, additional transfer of political power from a national to Union's level. This makes things even more complicated as the issue of national sovereignty remains sensitive in several EU member states. On the top of this, there is no an intellectual consensus on both crisis origins (flaws of a common currency project vs. unsustainable fiscal policies) and optimal design of fiscal and macroeconomic management within the single currency area.

The purpose of this paper is to address some of the above issues with the special emphasis given to fiscal origins of the current phase of the crisis, policy remedies (including changes in

¹ This is the updated and revised version of the earlier paper on "Euro crisis or fiscal crisis: looking for the right diagnosis and therapy" published in the CESifo Forum 2010 No. 4. The opinions expressed here are solely the author's; they do not necessarily reflect the views of CASE Network.

² For periodization of the recent global financial crisis see Pomfret (2012).

the EU/EMU integration architecture) and risks to the stability of monetary union's institutional and political design in case of wrong policy responses.

The paper is organized as follows: Section 2 tries to diagnose the nature of the current phase of financial crisis and its origins. This is followed by Section 3 which analyzes causes of fiscal imbalances. Section 4 discusses fiscal policy responses and Section 5 – monetary policy responses to the crisis. Section 6 focuses on changes in EU/EMU integration architecture required to strengthen institutionally the common currency project in future. Finally, Section 7 offers tentative conclusions and policy lessons.

2. Looking for the right diagnosis: the Euro crisis or sovereign debt crisis?

Many analysts and commentators speak about the Euro crisis but this is not a right diagnosis, at least yet. A currency crisis can be defined as a sudden decline in confidence in a given currency, leading to a speculative attack against it and resulting in its substantial depreciation. Nothing like this has happened with the Euro so far. Instead we observe a sovereign debt crisis in a number of Eurozone countries and beyond. However, one cannot rule out the scenario when wrong diagnosis and wrong therapy will undermine, at some point, credibility of Euro as the currency and political consensus behind the common currency project. We will return to this question in Section 5.

2.1. Fiscal crisis in developed countries and the EU

So far the attention of public opinion and analysts concentrated on the fiscal problems of the so-called Eurozone periphery – Greece, Ireland and Portugal, more recently also on Italy and Spain. However, as can be seen from Table 1, dramatic increase in public debt to GDP ratio was recorded in most EU members states and other major developed economies.

At the end of 2011, according to the IMF World Economic Outlook (WEO) statistics, the gross public debt of 12 out of 17 members of the EMU (all but Estonia, Finland, Luxembourg, Slovakia and Slovenia) exceeded a 'Maastricht' limit of 60% GDP, and the same situation concerned 2 non-EMU members of the EU (Hungary and the UK). The threshold of 80% was exceeded by 9 EU member states: Belgium, France, Germany, Greece, Hungary, Ireland, Italy, Portugal and the UK. Looking at these numbers the popular perception that Eurozone is divided between the fiscally prudent 'North' and imprudent 'South' looks questionable. Actually, the debt-to-GDP level of Germany and France remains higher comparing to crisis-affected Spain. As result of fiscal deterioration in the largest member states the entire EU debt exceeded 80% of its GDP and the Eurozone – reached the level close to 90% of its GDP. Outside the EU situation looks even worse with the US gross public debt exceeding the level of 100% of GDP and Japan's – well above the level of 200%.

The debt dynamics have been even more worrying: during the crisis period (2007-2010) the global gross public debt to GDP ratio (including developing countries which perform much better) increased by 17.2 percentage points of GDP. The EU's ratio recorded increase by 22.9 p.p. between 2007 and 2011. In case of the Eurozone it increased by 21.7 p.p. at the same period.

Only five EU member states – Estonia, Germany, Hungary, Latvia and Sweden – managed to improve somewhat their debt to GDP ratios in 2011, comparing to 2010. In all other EU countries they further deteriorated, in some cases quite dramatically, for example in Greece by

18 percentage points of GDP, in Portugal – by 13.4 p.p., in Ireland – by 12.5 p.p., in Cyprus – by 10.5 p.p., in Slovenia – by 8.5 p.p., in UK – by 7.4 p.p., in Spain – by 7.3 p.p.

Table 1: General Government Gross Debt-to-GDP ratio in the EU and other developed countries, 2007-2012

Country	2007	2008	2009	2010	2011	2012
World	62.1	65.2	75.6	79.3	79.6	80.0
EU	59.5	64.0	74.4	79.6	82.4	84.5
EMU members						
Eurozone	66.4	70.2	79.9	85.7	88.1	90.0
Austria	60.2	63.8	69.5	71.8	72.2	73.9
Belgium	84.1	89.3	95.9	96.2	98.5	99.1
Cyprus	58.5	48.6	58.3	61.3	71.8	74.3
Estonia	3.7	4.5	7.2	6.7	6.0	5.7
Finland	35.2	33.9	43.5	48.4	48.6	51.6
France	64.2	68.3	79.0	82.4	86.3	89.0
Germany	65.2	66.7	74.4	83.2	81.5	78.9
Greece	105.4	110.7	127.1	142.8	160.8	153.2
Ireland	24.8	44.2	65.2	92.5	105.0	113.1
Italy	103.1	105.8	116.1	118.7	120.1	123.4
Luxembourg	6.7	13.7	14.8	19.1	20.8	23.8
Malta	62.3	62.3	68.0	69.4	70.9	71.4
Netherlands	45.3	58.5	60.8	62.9	66.2	70.1
Portugal	68.3	71.6	83.1	93.4	106.8	112.4
Slovakia	29.6	27.9	35.6	41.1	44.6	47.1
Slovenia	23.1	21.9	35.3	38.8	47.3	52.5
Spain	36.3	40.2	53.9	61.2	68.5	79.0
Non-EMU EU members						
Bulgaria	18.6	15.5	15.6	16.7	17.0	21.3
Czech Rep.	28.0	28.7	34.3	37.6	41.5	43.9
Denmark	34.1	41.9	41.5	43.4	46.4	51.3
Hungary	67.0	72.9	79.7	81.3	80.4	76.3
Latvia	7.8	17.2	32.9	39.9	37.8	39.1
Lithuania	16.8	15.5	29.4	38.0	39.0	40.9
Poland	45.0	47.1	50.9	54.9	55.4	55.7
Romania	12.7	13.6	23.8	31.2	33.0	34.2
Sweden	40.2	38.8	42.5	39.4	37.4	35.5
UK	43.9	52.5	68.4	75.1	82.5	88.4
Other developed countries						
Canada	66.5	71.1	83.6	85.1	85.0	84.7
Japan	183.0	191.8	210.2	215.3	229.8	235.8
US	67.2	76.1	89.9	98.5	102.9	106.6

Note: yellow fields indicate IMF estimates/ forecasts

Source: IMF WEO database, April 2011 (September 2011 in case of world's data)

The short-term perspective does not look rosy too. According to the IMF forecast of April 2012 (see Table 1) in the entire EU except Estonia, Germany, Greece³, Hungary and Sweden the debt to GDP ratio is going to deteriorate further in 2012.

³ Improvement in Greece's debt-to-GDP ratio will be possible due to the debt reduction agreement with private creditors concluded in March 2012.

2.2. The Eurozone specific factors

Summing up, as documented in previous section, the new round of macroeconomic and financial turmoil has been caused by a widespread fiscal crisis which affected most of the developed world and its largest economies such as Japan, US, Italy, France, Germany, Canada and UK. Contrary to popular perception, this is not the phenomenon limited to the Eurozone periphery and to the Eurozone itself. The only factor which is specific to the EMU concerns uncertainty related to the debt resolution mechanism, i.e. how the burden of debt restructuring will be eventually shared between a troubled country and its single currency partners and which part of this burden will have to be absorbed by private creditors.

The above uncertainty has resulted from financial market misperception of the Eurozone architecture and wrong rescue policies rather than Treaty's regulations themselves. On the contrary, the Article 125 of the Treaty of the Functioning of the European Union is quite clear in this respect: it prohibits any direct bailout of member states. However, in spite of the letter of the Treaty, financial markets seemed to assume a some degree of collective Eurozone's fiscal responsibility since the beginning of the Euro project as evidenced by very low spreads on sovereign bond yields prior to 2008 (regardless sharp differences in fiscal positions of individual countries). Unfortunately, after the fiscal crisis in the Eurozone periphery began in early 2010 this implicit assumption became validated by ad hoc rescue packages provided to EU member states in troubles (*de facto* against the Treaty's no-bailing out principle) and undertaken under the pressure of financial markets to avoid their panics and broader contagion effect. Only the subsequent rescue package for Greece of March 2012 included the mechanism of *de facto* partial sovereign default (dressed up legally as the voluntary debt restructuring).

2.3. Changes in financial markets attitude to sovereign debt

One may put a legitimate question why financial markets changed so radically their attitude to sovereign debt financing, especially in respect to the Eurozone periphery? Why they were debt tolerant for so long and became so nervous recently? The right answer seems to refer to the rapidly changing global macroeconomic and financial environment after 2007.

In the pre-crisis period of relatively high economic growth and abundance of cheap finance which originated from the surplus savings in Asia and in oil-producing countries lending to governments looked relatively safe and attractive. Most countries recorded either gradual decrease or at least stabilization of their debt-to-GDP levels.

The rapid deterioration of the global public debt to GDP level and perspective of slower GDP growth in a medium term means that financing becomes relatively more expensive and difficult to obtain. There is an increasing global competition for scarce financial resources both between private and public sectors (the former being crowded out by the latter) and within the public sector itself. Countries with uncertain macroeconomic and fiscal perspectives are losing to those with a more solid credit reputation. However even those who were considered by financial markets as safe havens not so long time ago have now a good reasons to fear about their credit ratings and debt sustainability perspective. With low growth or no growth in the next few years the debt-to-GDP level will continue to grow (see WEO, 2012, Table A8, p. 204) putting their debt solvency perspective under question. As result, the perception of the 'safe' debt level (or the threshold of debt intolerance – see Reinhart and Rogoff, 2009, pp. 21-33) is changing rapidly leading to massive sovereign rating downgrades and capital outflows from public debt market of individual countries.

This has also an impact on the debt sustainability perspective within the EU and Eurozone. In the pre-crisis environment investors might expect that in case of isolated debt service problems faced by countries with the highest debt-to-GDP ratios like Greece other EU/EMU members will have enough fiscal room to provide them a rescue package (even if such expectations went against the Article 125 of the TFEU). Now when most of EU countries, including France, Germany and the UK, face serious fiscal challenges themselves and there are more candidates for actual or potential rescue this kind of assumption is not justified anymore.

The additional constraints come from continuous financial deleverage in many countries (as result of bursting bubbles in 2007-2008) and from the regulatory reform in the banking sector (especially increasing capital adequacy ratios and liquidity requirements) which make lending more scarce and expensive, other things being equal. If the idea of new banking or financial transactions tax materializes it will add to lending costs even more and will further slow economic growth.

3. Causes of the sovereign debt crisis

Which factors led to such unprecedented deterioration of fiscal accounts in most of developed countries? The recession of 2008-2009, high costs of financial sector rescue and resulting high budget deficits played, of course, an important role. However, the negative fiscal trends in all major economies started earlier - either at the beginning of 2000s (the US and most of the EU) or already in 1990s (Japan). In case of US these were the costs of the war on terror and generous tax incentives aimed to overcome consequences of the dotcom recession in 2001. In case of Japan this was the effect of long stagnation in 1990s, subsequent unsuccessful attempts to reactivate economy through the aggressive fiscal stimulus and costs of banks restructuring after the 1990 financial crisis. Finally, in the EU this was a combination of the slowdown (similar to that of US) and relaxation of fiscal discipline in early 2000s which led, among others, to partial dismantling of the Stability and Growth Pact in 2005.

During the boom years of 2003-2007 policymakers were overoptimistic about the long-term potential growth of their economies and largely forgot about adverse fiscal consequences of forthcoming population aging. They were also misled by the unexpectedly high revenue elasticity of this particular business cycle. In the boom years, budget revenues in several countries grew much faster than nominal GDP, the trend which was then abruptly reversed after the 2008-2009 recession had started. The nature of these windfall revenues requires a more in-depth analysis.

In the wake of 2007-2009 crisis the costs of financial sector rescue were largely underestimated and potential of a countercyclical fiscal policy – overestimated. These are the important lessons for future.

In the globalized economy fiscal stimulus on a national level has tendency to ‘leak’ outside a given economy⁴. The cross-border coordination of fiscal stimuli, even within the EU, proves problematic for many reasons (see Dabrowski, 2010). In addition, in the environment of

⁴ Unless it is accompanied by protectionist measures. Fortunately, the incidence of protectionist measures during the 2008-2009 recession was limited, especially within the EU.

excessive private and public indebtedness economic agents prefer to increase their net saving rather than spend more. As result, the potential spending multipliers have been smaller than experienced in the previous business cycles (they must exceed 1 to ensure stimulus be self-financing).

More generally, the recent business cycle experience gives a good food for thought about limited practical usefulness of such traditional concepts as the potential output and cyclically adjusted fiscal balance (difficult to be estimated ex-ante when the business cycle is irregular), internationally agreed definitions of public debt (which do not include unfunded liabilities of the public pension and healthcare systems, and contingent liabilities in the financial sector) or even such popular measure as the debt-to-GDP ratio which tells very little about country's long-term fiscal sustainability, especially in good times.

If one analyzes the political economy dimension of the discretionary fiscal policy its asymmetrical potential becomes very clear. It is politically easy to provide fiscal stimulus but it is much more difficult to withdraw it. The US experience with tax incentives of the Bush era or the 2008-2009 stimulus package both intended to be only temporary are very telling here.

4. Fiscal policy responses

As the current stage of financial crisis has a predominantly fiscal nature the policy responses must aim, in first instance, at reducing fiscal imbalances. While this general recommendation seems to be hardly questionable the issue of timing and exact composition of fiscal adjustment packages in individual countries raises a lot of controversies. Generally speaking, one can distinguish between two opposite camps – of those who argue in favor of immediate fiscal tightening even if this means a pro-cyclical fiscal policy in the time of downturn and those who advocate a more cautious approach with either more gradual fiscal adjustment or even continuation of anti-cyclical fiscal policy until economy starts to recover.

4.1. Growing out of the debt?

The critics of fiscal austerity (see e.g. Soros, 2012) are afraid that it will bring more output decline and more unemployment and will lead to further deterioration of debt-to-GDP ratios, i.e. creating some kind of self-perpetuating downward spiral and, as result, producing negative political effects (a fertile soil for populist forces). Such fears seem to be at least partly justified if one looks at GDP decline/ stagnation in those EU economies which already adopted fiscal austerity packages (the UK, Ireland, Portugal, Greece, Italy and others). There is little hope for the so-called non-Keynesian effects of fiscal tightening, even if such effects could be sometimes observed in the past (see Siwinska & Bujak, 2006).

However, even if one does not want to accept unpleasant short-term output and employment consequences of fiscal tightening the question is about alternative. Such alternative is rarely presented in terms of operational macroeconomic projection with taking account on debt sustainability constraints. Rather this is a general belief that economy can grow out of the excessive debt-to-GDP level without necessity to improve radically primary its fiscal balance just now. Again such a belief is based on several, usually implicit, assumptions: that fiscal multiplier is higher than one, the level of business activity is below the potential and government has enough fiscal room and credibility to borrow on the market to buy additional time before growth returns to its potential.

As we mentioned before, such expectations and assumptions were already negatively verified in 2008-2009: In spite of quite rapid growth recovery since the mid 2009 (and until mid 2011) fiscal accounts did not return to their pre-crisis level and most of developed countries entered the unsustainable fiscal path as demonstrated by Table 1. Looking back, they did not have enough fiscal room for countercyclical fiscal policies in 2008-2009. And this is even less realistic perspective in the foreseeable future because of much higher indebtedness, increasing debt intolerance, and poor growth perspective in a near future.

Even of the current slowdown/recession will be short living the economic growth will not come back to the pace of 1990s or mid-2000s soon. First, as mentioned before, financial deleveraging and financial sector reform will negatively influence growth potential for quite long time. Second, there are no new substantial growth impulses similar to those which happened in 1990s (peace dividend after the end of 'Cold' war, economic opening of China, India and the former communist countries, global trade liberalization, ICT revolution). Third, both monetary and fiscal policies which stimulated growth in the mid -2000s will have to be more restrictive now.

4.2. Fiscal adjustment backed by microeconomic and institutional reforms

Since growing out of the debt looks unrealistic one should consider two other options: fiscal adjustment backed by microeconomic and institutional reforms and debt restructuring. Both are politically and socially painful and both involve substantial negative side effects (as described in the previous subsection), at least in short-term. However, only these two options offer durable solutions.

Fiscal adjustment, by its nature, addresses the core roots of debt crisis, i.e. allows improving primary fiscal balance and decrease in debt service costs. If concentrated on spending reduction rather than on rising taxes and backed by well-designed microeconomic and institutional reforms (for example, rationalizing welfare programs, increasing elasticity of labor, product and service markets, financial sector reform) they may increase country's growth potential in a medium-to-long run. However, the short-term output and employment costs (and therefore additional negative fiscal shock) are hardly avoidable.

Furthermore, as most of developed economies must follow the same path one may expect slower global growth in a short-term. No additional demand support can be expected from emerging markets either because most of them will have to fight with their macroeconomic overheating.

Institutional reforms should also aim to diminish financial sector's contingent fiscal liabilities in future. One of the key issues here is addressing 'too big to fail' problem, i.e. decreasing the market share and political bargaining power of the so-called systemically important financial institutions (SIFI). The reform should also decrease pro-cyclicality of financial sector regulations.

4.3. Debt restructuring

In some cases like Greece the debt burden is so high that fiscal consolidation although necessary is not sufficient to return country's solvency. This is why debt restructuring must be also considered as the part of adjustment packages. Obviously, this is costly solution for lenders and involves other negative side-effects. For example, it may trigger a cross-border contagion on sovereign debt market and in the entire financial sector. However, it is

sometimes unavoidable. Sooner it will be done and in orderly fashion (i.e., through negotiations of all interested parties like in the case of Greece) the eventual cost of debt restructuring will be smaller. Excluding up front this option, as some governments in Europe try to do, is neither realistic nor creating right incentives for both creditors and borrowers. And negotiated debt restructuring or even unilaterally declared (“messy”) sovereign default of any Eurozone country does not mean automatic breaking up the common currency area. Economic history gives us several examples of sovereign defaults under the gold standard (see Reinhart & Rogoff, 2009) or in individual US states (Gros, 2010) which caused neither monetary nor political disintegration.

5. Monetary policy responses

5.1. General remarks

Central banks have also the role to play in supporting fiscal adjustment, mostly through adopting a more accommodative monetary policy stance to compensate negative demand effects of fiscal tightening. However, there are clear limits of monetary accommodation, i.e., it cannot allow inflation to grow above central bank’s target, it must not compromise central bank’s independence, and it should not involve quasi-fiscal operations which blur boundaries between monetary and fiscal policies.

Unfortunately, not all the policy proposals floated in the public debate respect the above limits. Below we will discuss two of the most controversial proposals and then we will review the actual ECB practices with special focus given to ECB’s institutional vulnerabilities.

5.1. Inflating out the debt overhang

Real depreciation of the accumulated debt burden through higher inflation is a suggestion which, directly or indirectly, appears in the policy debate especially in the context of skepticism *vis a vis* rapid fiscal adjustment⁵. Indeed, this is a policy option which may work to some extent (until financial markets will start to charge an inflation-related risk premium) and only in those countries which do not have substantial debt denominated in foreign currency⁶. However, the negative side effects of such a policy – higher inflationary expectations, building up inflationary inertia, price/ wage indexation practices and lower central bank credibility – may be serious, long lasting and devastating consequences for both growth perspective and financial stability.

In case of the Eurozone it may involve the additional risk of undermining cross-country political consensus around a common currency. Countries less burdened with a public debt and more committed to price stability may consider paying an inflationary price for inflating out others’ debts as economically and politically unacceptable.

⁵ The benefits of higher inflation for the post-crisis macroeconomic policy were first discussed in a complex way by Blanchard, Dell’Ariccia & Mauro (2010).

⁶ Depreciation of domestic currency which may result from a pro-inflationary policy will increase the debt service burden in both nominal and real terms.

5.2. ECB as the ‘lender of last resort’ to governments

The proposal that the ECB should declare unlimited and unconditional purchase of debt instruments issued by the Eurozone governments in case of market distress (see e.g. Bofinger & Soros, 2011) sounds even more controversial and risky than a “moderate” inflation scenario discussed in the previous subsection.

The idea that the ECB may serve as the ‘lender of last resort’ (LOLR) to governments is deeply flawed and based on doubtful theoretical foundations. Central banks can play such a role in respect to commercial banks supplying them with temporary liquidity to avoid depositors’ panic.⁷ In practice, however, there is often difficult to distinguish bank’s illiquidity from its insolvency (see Goodhart, 1987). This is even truer in case of sovereign debt where market perception of government’s solvency is conditional on various ex ante assumptions hardly verifiable and subject of multiple equilibria.

Thus calling the ECB to play the role of LOLR on the sovereign debt market means no less than asking this institution to monetize government debt and print money without limits⁸. This may be the shortest path from the sovereign debt crisis which Europe faces now to the genuine Euro crisis and collapse of the common currency project.

5.3. The increasing scale of ECB’s rescue activities

While the ECB did not follow the advice to play the role of LOLR to governments it became increasingly engaged in providing indirect financial support to countries and governments in troubles. This included, among others, subsequent lowering of quality requirements for lending collateral, opening special refinancing facilities for banks in the troubled countries which cannot provide even such lower-quality collateral⁹, and finally – the Long Term Refinancing Operations (LTRO) launched at the end of 2012. Although all these measures have been justified publicly on either monetary policy or financial stability ground most of them has a quasi-fiscal characteristic.

As in case of the other forms of bailout there is a trade-off between short-term policy needs and their long-term consequences. The quasi-fiscal interventions of the ECB can bring yields on treasury bonds down and improve financial markets’ mood for a while. They help to avoid immediate cross-country contagion effect and allow buying time to adopt corrective measures in other policy areas. However, they can produce several negative side effects. First, they can undermine ECB’s reputation as the truly independent central bank what, in turn, can negatively influence stability of the Euro. Second, they may have potential inflationary and

⁷ This is the consequence of fractional reserve banking system with less than 100% reserve requirement and with its imminent mismatch between long-term assets and short-term liabilities.

⁸ The frequent references to quantitative easing (QE) operations conducted by the US Federal Reserve Board, Bank of Japan or Bank of England are incorrect for at least two reasons. First, the above banks purchase government bonds on secondary market (apart from other kinds of financial assets) within the quantitative limits set from the point of view of monetary policy goals. These purchases are neither unlimited nor unconditional. Second, the ECB has also conducted QE operations increasing its monetary base when it has considered necessary from the monetary policy point of view.

⁹ The Emergency Liquidity Assistance (ELA) which is provided against the guarantees of national government who is already insolvent. In monetary policy terms, ELA can be interpreted as the ECB license granted to a national central bank in the troubled country to issue unlimited amount of money to stop a potential banking panic and cushion financial strains caused by government insolvency. See Gros (2012) analysis in respect to Greece.

fiscal consequences and, therefore, undermine cross-country political consensus around the common currency (see the next subsection). Third, they create wrong incentives for private investors and encourage moral hazard. The investors who did not hesitate to accept higher risk in exchange for higher yields would receive risk insurance for free. Fourth, the increasing involvement of the ECB in various segments of financial market crowds out private sector transactions. As result, the role of interbank lending and interbank settlements decreases in favor of ECB refinancing, ECB deposits and Target2 payment transactions. Finally, there is a danger that large-scale market interventions of the ECB, especially the LTRO, leads to reducing cross-country lending exposures in favor of in-country lending (see Soros, 2012).

5.4. ECB's institutional vulnerabilities and risk of the Eurozone breakup

The larger currency areas with stable and credible currencies and less exposed to external shocks have relatively more room of maneuver in their monetary policy making comparing to small open economies. And this is the case of the Eurozone. On the other hand, one must remember that the common currency project in Europe is relatively fresh and subject of delicate political compromise between its founding nations which have historically varied in terms of their attitude to monetary and fiscal stability and central bank's independence. This is an important factor which limits potential of non-orthodox policies of the ECB (comparing, for example, to that of the US Federal Reserve System) and makes it vulnerable to any confidence crisis between EMU member states.

As far as the ECB follows its statutory rules, its reputation and credibility of the Euro seem to remain unchallenged even in the extreme case of exit of any peripheral country from the common currency area (see below). However, if it departs from these rules and becomes involved in large-scale quasi-fiscal activities it may lead to both inflationary consequences and market confidence crisis (even if financial markets welcome such quasi-fiscal interventions in short term).

It may also raise the question of deteriorating quality of its assets and resulting capital losses which will have to be eventually covered by the Eurozone member states. Furthermore, as quasi-fiscal activities are mostly targeted to peripheral countries in troubles the question of cross-country redistributive effects of ECB's interventions may become a hot political issue. The emerging debate on the Target2 imbalances (see Sinn & Wollmershaeuser, 2011; Bijlsma & Lukkezen, 2012) is perhaps a signal that this is not a purely hypothetical threat.

Summing up, the high costs of leaving the common currency area for any single member country makes the EMU project more sustainable than its critics and forecasters of its quick demise would like to see. Nevertheless, there are limits of this sustainability. At some point, combination of inflation concerns (see above), the undermined credibility of the ECB and Euro and awareness of fiscal consequences of ECB quasi-fiscal activities can trigger centrifugal tendencies among its core members. They may decide to leave the monetary union even if it involves undermining their export competitiveness (because the new currency/ies of the leaving countries will probably appreciate against Euro).

The opposite case when the peripheral country in troubles would like to leave the Eurozone voluntarily and reintroduce its own (weaker) national currency looks much more difficult, and therefore, less likely because all its outstanding private and public liabilities would remain denominated in Euros. Therefore, exiting the Euro would mean an immediate default on both public and most private debt, caused by soaring debt-to-GDP ratios. Furthermore, such an exit

could not happen technically overnight and the very first steps in this direction would already trigger total financial chaos and loss of market confidence not only in an exiting country.

Nevertheless the peripheral country in troubles may be forced to reintroduce its national currency as the consequence of either its sovereign default resulting in insufficient revenue cash flow to cover current government expenditures or banking crisis. Both scenarios assume cutting off external financial support as result of country's failure to implement adjustment program agreed with the IMF, European Commission and ECB. Both can lead to high inflation or hyperinflation.

6. Changes in EU/EMU integration architecture: what kind of fiscal union?

Part of discussion concerns the reform of EU institutions to increase Union's capacity to deal with the current crisis and minimize danger of its repetition in future. In this context many speak about necessity to complement the EMU with the fiscal union. However, less clear is what such a fiscal union would mean in practice.

Definitely, the EMU needs more fiscal discipline on the national level¹⁰ to minimize the risk of free riding under the umbrella of common currency what has been one of principal causes of the current crisis. However, fiscal troubles of non-Eurozone EU members will also have negative repercussions for both the Union and outside world. Hence, fiscal stability and prudence should be considered as an important European public good and apply equally to all EU members regardless they are part of the Eurozone or not.

In this context the effort to strengthen fiscal surveillance rules under the Stability and Growth Pact and reinforce its both "preventive" and "corrective" arms (including automatic and meaningful sanctions) are going in the right direction. The same can be said about the new intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and EU's secondary legislation which pushes EU member states towards enhancing their national fiscal rules and institutions either through constitutional changes or equivalent legislation.

Another step towards strengthening EU fiscal federalism involves building a permanent debt resolution mechanism on the EU level - the European Stability Mechanism (ESM) which will replace the European Financial Stability Facility (EFSF), the temporary mechanism established in May 2010. The ESM is to start its operations in mid-2012.

Ideally, the permanent resolution mechanism should correctly balance punishment for past irresponsible behavior (including the orderly sovereign default/ restructuring mechanism), incentives to correct past mistakes and elements of financial aid to smooth the painful adjustment process. It should also relieve the ECB from its current engagement in assisting countries in troubles. It remains to be seen whether the ESM will meet these expectations.

The experience of both 2008-2009 and current phase of a banking crisis calls for building a truly pan-European system of banking supervision and crisis resolution mechanism, including the EU wide system of deposit guarantees and extending the ESM mandate towards temporary recapitalization of the troubled banks (see Pisani-Ferry, 2012; Schoenmaker &

¹⁰ The EU runs a balanced budget so the problem of fiscal discipline on the Union level does not exist.

Gros, 2012; Soros, 2012). This is critically important for avoiding a national bias in the bank rescue programs and it would constitute another form of enhanced fiscal federalism.

Regretfully, not all “federalist” proposals go towards strengthening fiscal discipline and eliminating moral hazard and free riding. This refers to the idea of Eurobonds¹¹, which are to be jointly issued/ guaranteed by the EMU members. They can lead to weakening fiscal discipline on national level and creating adverse incentives rather than serving fiscal consolidation and avoiding moral hazard. The practice of fiscal federalism in many countries gives an evidence of negative consequences of sharing responsibility for the debt of subnational governments with federal/ national authorities.

Some other ‘federalist’ ideas are interesting but do not necessarily address the challenge created by the sovereign debt crisis. The proposal of harmonizing tax bases and (more controversially) tax rates across the EU should be discussed in the context of functioning of the Single European Market rather than crisis prevention and resolution. The same relates to the proposal that in future the EU budget should be higher than the current 1% of Union’s GDP and be based, to a larger extent, on its own revenues rather than member countries’ contributions. Perhaps yes but this depends on which additional policy tasks and responsibilities could be transferred from the national to the EU level and whether such a transfer would offer higher efficiency in their implementation.

7. Tentative conclusions and policy lessons

Although the current phase of the global financial crisis is far from being over there are some conclusions which can be drawn and some tentative lessons to be learnt.

First, unlike in the years of 2007-2009 (when insolvency and illiquidity of large banks in the US and Europe were a major problem) the current round of the global financial crisis has evidently fiscal origins and they are more serious and widespread than usually perceived. Almost all developed countries suffer from the excessive public debt burden and, in the context of slow-growth prospects, there is no easy way to get rid of this burden. In one way or another, each country will have to conduct fiscal adjustment even if this involves economic and political costs in terms of lower output and higher unemployment. Countries with a relatively lower debt-to-GDP ratio and which continue enjoying good reputation as sovereign borrowers have more room of maneuver, i.e., they can adopt more gradual adjustment scenarios. Countries already considered as bankrupts or close to insolvency must adjust immediately and in a credible way to convince both financial markets and other economic agents that they can go out of troubles without further negative spillovers.

Second, central banks can support fiscal adjustment and reduce its economic and social costs through adopting accommodative monetary policy stance. However, there are natural limits of central banks involvement determined by both priority and credibility of their anti-inflationary mission and institutional independence. In case of ECB there are additional risks and vulnerabilities coming from its institutional design which is based on cross-country consensus enshrined in the Treaty and ECB operational rules. Too excessive ECB involvement in quasi-fiscal rescue operations can easily undermine this consensus and lead to Eurozone disintegration which, fortunately, was avoided so far.

¹¹ First time this idea was presented publically soon after launching the Euro in Giovannini et al. (2000) report. Recently the European Commission (2011) analyzed in its Green Paper three potential options of the so-called Stability Bonds.

Third, in both fiscal and monetary policy spheres there is constant trade-off between short-term interventions aimed in cushioning market panics and buying time for designing and adopting more complex reform measures and long-term risks in terms of encouraging moral hazard behavior and building an even higher debt exposure. While the risk of a far-going financial market contagion based on multiple equilibria creates the real challenge for policymakers in the world of free capital movement they must be able to resist market pressures (often amplified by media) and give preference to the solutions which address the real causes of the problem.

Fourth, the conceptual and instrumental foundations of a countercyclical fiscal policy require serious reconsideration, in the light of both 2007-2009 and more recent experience.

Fifth, the experience of the global financial crisis in its 2007-2009 banking phase and the current (largely fiscal) phase calls for further fiscal integration on the EU level. However, this does not mean that each proposal going towards greater fiscal federalism is rational from the point of view of solving real challenges and creating right incentives. While the steps towards stronger fiscal discipline rules on both the EU and national levels as well as building the EU rescue facilities in respect to sovereigns and banks (based on strong policy conditionality) make sense this is not the case of Eurobonds.

References:

- Bijlsma, M. & Lukkezen, J. (2012): *Why is there no TARGET2 debate in the US?*, BRUEGEL, post on the BRUEGEL blog, April 2, <http://www.bruegel.org/nc/blog/detail/article/729-why-is-there-no-target2-debate-in-the-us/>
- Blanchard, O., Dell'Ariccia, G. & Mauro, P. (2010): *Rethinking Macroeconomic Policy*, IMF Staff Position Note, SPN/10/03, February 12
- Bofinger, P. and Soros, G. (2011): *Only way to stop the run on eurozone debt*, Financial Times, November 21, <http://www.ft.com/intl/cms/s/0/4f29ab54-1431-11e1-85c7-00144feabdc0.html#axzz1gRCoxjhP>
- Dabrowski, M. (2010): *The Global Financial Crisis: Lessons for European Integration*, Economic Systems, Vol. 34, Issue 1, pp. 38-54
- European Commission (2011): *European Commission Green Paper on the feasibility of introducing Stability Bonds*, MEMO 11/820, Brussels, November 21, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/820>
- Giovannini, A. et al. (2000): *Coordinated Public Debt Issuance in The Euro Area - Report of the Giovannini Group*, http://ec.europa.eu/economy_finance/publications/publication6372_en.pdf
- Goodhart, C. (1987): *Why Do Banks Need a CB?*, Oxford Economic Papers, vol. 39, 75-89.
- Gros, D. (2010): *Learning from the US experience?*, CEPS Commentary, April 30
- Gros, D. (2012): *Greece's Soft Budgets in Hard Times*, CEPS Commentary, March 7

Pisani-Ferry, J. (2012): *The case for a European banking union*, BRUEGEL, post on the BRUEGEL blog, May 31, <http://www.bruegel.org/nc/blog/detail/article/800-the-case-for-a-european-banking-union/>

Pomfret, R. (2012): *The Post-2007 Crises and Europe's Place in the Global Economy*, CASE Network Studies and Analyses, No. 439, May

Reinhart, C.M. and Rogoff, K.S. (2009): This Time Is Different. Eight Centuries of Financial Folly, Princeton University Press

Schoenmaker, D. & Gros, D. (2012): *A European Deposit Insurance and Resolution Fund*, CEPS Working Document, No. 364, May.

Sinn, H-W. & Wollmershaeuser, T. (2011): *Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility*, NBER Working Papers, No. 17626, November, <http://www.nber.org/papers/w17626>

Siwinska, J. & Bujak, P (2006): *The Short-Run Macroeconomic Effects of Discretionary Fiscal Policy Changes*, in: Dabrowski, M. & Rostowski, J. (eds.): The Eastern Enlargement of the Eurozone, Springer

Soros, G. (2012): *Remarks at the Festival of Economics*, Trento, Italy, June 2, http://www.georgesoros.com/interviews-speeches/entry/remarks_at_the_festival_of_economics_trento_italy/

WEO (2012): World Economic Outlook, International Monetary Fund, Washington, DC, April