THE CRISIS OF THE EURO AND NEW EUROPEAN GOVERNANCE: FISCAL UNION AS SOLUTION?

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Abstract
This paper presents a set of crucial events, arguably deemed to be the cause of the recent economic crisis, and tries to come up with a connection between the global and euro crisis.
It begins with the presumption that the existing crisis in the euro zone can only be overcome with appropriate institutions and persistent measures of economic policy. Through a detailed analysis of existing and announced policy tools, this paper tries to identify ways of further development, by discussing the necessity of creating a fiscal union in the euro area.
Keywords*: global crisis, euro crisis, economic policy, institutions, new governance, fiscal union.*

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1. Introduction

The first strains in the financial markets begin to emerge in the summer of 2007, when a few important American financial institutions decided to reduce their exposure to subprime mortgage-backed securities. The turmoil intensified during the next few months, generating a standstill in the interbank markets. The crisis spread rapidly across all major markets and regions, negatively affecting the "real economy" as of 2008. However, it appears that the roots of this crisis grow much deeper.

After the collapse of the Bretton Woods system, the United States banking sector initiated a long process of deregulation and liberalization of financial markets, whose completion has been reflected in the repeal of the "Glass Steagall Act" in 1999.[1] An increase in liquidity as a result of this decision, grew additionally following the tech *stock market crash* of 2000, when the Federal Reserve decided to respond with expansionary monetary policies. In June of 2004, the same central bank decided to reverse this trend by implementing more restrictive policies in order to combat inflationary pressures[2].

In response, the financial operators turned to increasingly risky markets, such as subprime loans, which were subsequently securitized in derivative products, and traded between financial institutions around the world.

It is precisely due to this securitization that insolvency problems, initially limited to the real estate sector, resulted in a real crisis of the entire credit market which has affected not only

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[1] In 1933, in the wake of the 1929 stock market crash and during a nationwide commercial bank failure and the Great Depression, two members of Congress put their names on what is known today as the Glass-Steagall Act (GSA). This act separated investment and commercial banking activities. At the time, "improper banking activity," or what was considered overzealous commercial bank involvement in stock market investment, was deemed the main culprit of the financial crash. According to that reasoning, commercial banks took on too much risk with depositors' money. Read more: http://www.investopedia.com/articles/03/071603.asp#ixzz24eAjVaTv
[2] For further information on the monetary policy of the Federal Reserve: http://www.federalreserve.gov/monetarypolicy/default.htm

the U.S., but also numerous other countries. More precisely, the abundance of liquidity which characterized the U.S. financial environment for years, caused a growing demand for real estate and consequently an increase in real estate prices.

The steady growth in the value of houses resulted in a greater guarantee on loans for purchase financing, and accordingly increased the issuance of loans due to subprime mortgages. Further growth in demand and property prices occurred, a process which seemed to be self-sustaining. However, when house prices began to fall, this trend was interrupted, leading to the "bursting" of the housing bubble. The decrease in the value of houses increased the insolvency of debtors, and banks turned to securitization of subprime mortgages in order to hedge the credit risk. The securities obtained from that process were not only sold to operators in the U.S., but also to those around the world.

2. The link between the global and the euro crisis

The first signs of internationalization occurred in August of 2007 as Iceland was starting to become affected by the same symptoms as the US financial and real estate markets. Subsequently, the economies of other countries felt the impact of the U.S. crisis. Thus, in the Old Continent, the reduction of financial wealth and greater credit rationing have established a vicious circle of decline in aggregate demand and an output contraction (Carlucci, 2010, pp. 14-18).

The summation of these events resulted in a great recession which particularly affected the labor market and the industrial sector, but also led to the deterioration of public accounts, caused a different direction of capital flows and reduced inflation. According to the Organization for Economic Co-operation and Development (OECD) in the period between October 2008 and March 2009, the Gross Domestic Product (GDP) of industrialized countries fell by 4% and the volume of international trade by about one-sixth.

In particular, the global crisis brought into question the sustainability of public finances in some of the euro zone countries, already affected by the sovereign debt crisis, placing the survival of the single currency at stake (Ibid, pp. 16-23). It should be emphasized that the growing public spending in hopes of tackling rising unemployment rates on one hand, and decreasing income and consequently tax revenues on the other, increased deficit / GDP and debt / GDP far beyond Maastricht criteria levels.

The sovereign debt crisis especially struck the so-called PIIGS countries including: Portugal, Ireland, Italy, Greece and Spain. As shown in Figure 1, each of these states has a public debt to GDP ratio higher than the euro zone average. Prior to the crisis, Spain's debt was below the EU average but it rapidly doubled following the emergence of the crisis.

Figure 1: Public debt in % of GDP (first semester 2012)

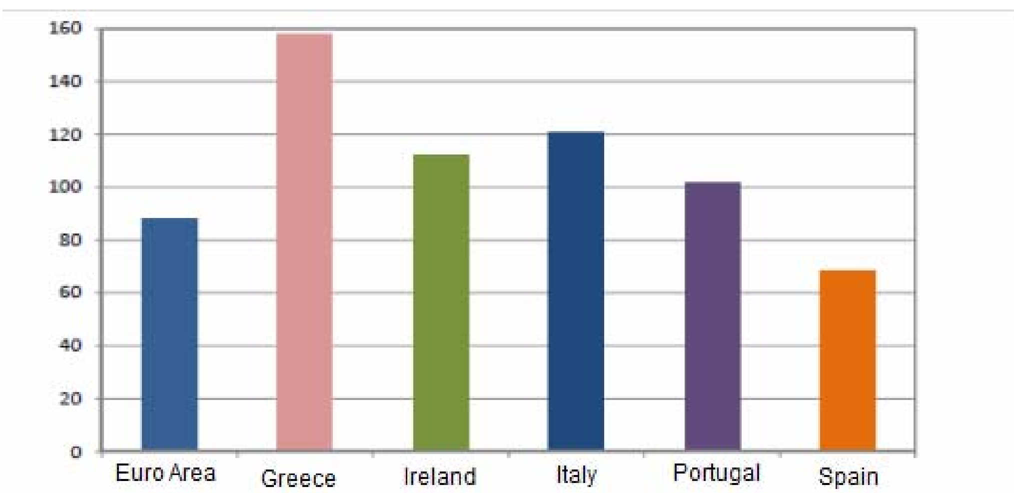


Figure 2 shows a sharp increase, in some cases above the threshold of 10% GDP, of the PIIGS's public debt following the default of Lehman Brothers

As of late, the situation has gotten even worse due to an increase in these values. It thus becomes evident that the PIIGS countries have a constant need for debt contracting; however the main question to ask is: " at what price"?

A conventional way to consider the level of market confidence in a particular country of the euro zone consists of observing the spread between the German government bond yields (bund), and the yields on government debts of other euro zone countries. If financial markets question the ability of a country to repay its debt, then they are going to look for higher interest rates (yields). If the spread increases, it means that debt contracting will become more expensive as in the case of PIIGS. Observing Figure 3, we can note that the spread between their bonds and German bunds widened in the last two years.

Figure 2: Public deficit in % of GDP

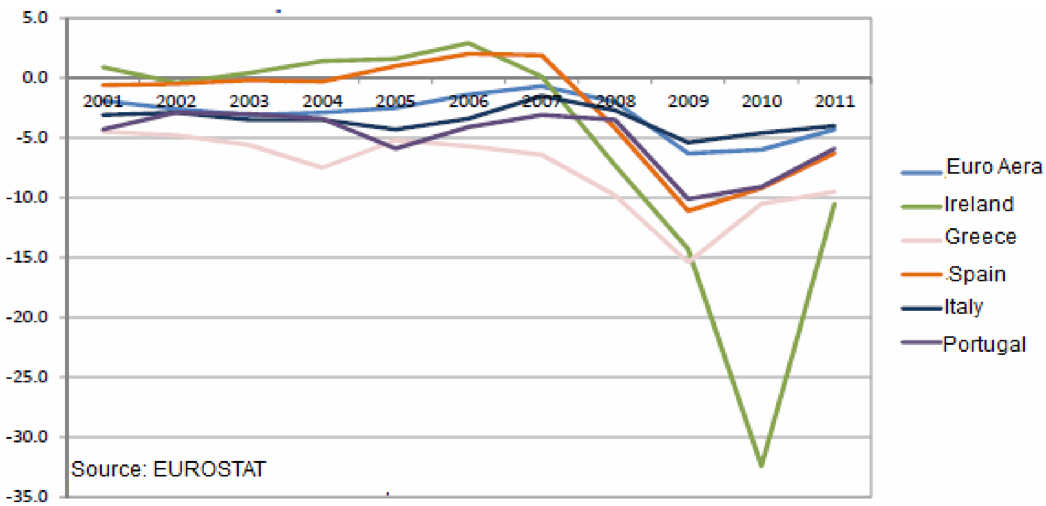
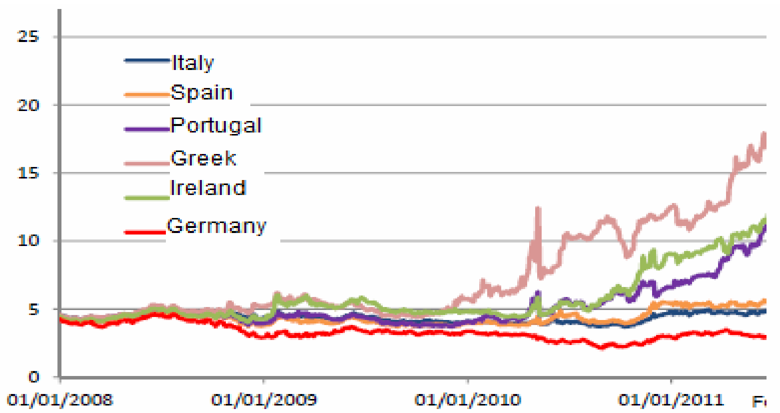


Figure 3: Government bond yields of the PIIGS countries and Germany



Source: Bloomberg

In fact, the deterioration of the budgetary situation within PIIGS countries did not originate in the same way. For an example, over the last couple of years, Greek budget deficits and *debt* levels have far *exceeded the limits* of the *Stability and Growth Pact (SGP)*. This remained unknown as the Greek government kept publishing false data which came to light only during the 2009 elections. In Spain and Ireland however, the deterioration of public finances has roots in the debt crisis of the private sector. The decision of the Spanish and Irish authorities to prevent the widening of private debt crisis caused very large public deficits.

3. New European Economic Governance

The need to reformulate the mechanisms and procedures that govern the European economic governance has emerged especially after the Greek sovereign debt crisis and the increasing risk of contagion in many countries of the euro area. The deficiencies are primarily attributable to ineffective control mechanisms and sanctions of the Stability and Growth Pact (SGP), a lack of closer coordination of economic policies and an inability to identify mechanisms able to prevent the euro zone countries from defaulting. In order to fill these gaps, *the EU institutions* are undertaking a comprehensive review of economic governance. At the spring meeting of the European Council from March 24th-25th of last year, the EU leaders have reached a historic agreement on a governance reform, which includes a slight amendment of the Treaties, the preparation of the Euro Plus Pact and the adoption of six legislative measures[3].

With regards to the slight amendment of the Treaties, it represents an adjustment of Article 136 of the Treaty on the Functioning of the EU (TFEU), inter alia strongly backed by Germany, as the creation of the permanent “Fund Save States" would not be compatible with its constitution. This amendment states that: “*The 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*”[4].

Another change concerns the so-called “Euro Plus Pact”, which actually represents a compromise reached on the "Pact for Competitiveness". The conclusions of the European Council contain a number of indicators relating to competitiveness, employment, fiscal sustainability and financial stability on the basis of which the control over the progress of individual states towards the achievement of common goals will be exercised. In concrete terms, the signatory countries are required to: review wage agreements and ensure that those in the public sector correspond to the effort of private sector competitiveness; eliminate unnecessary restrictions on professional services and retail trade; improve education systems and promote research and development, innovation and infrastructure; improve the business environment; reform the labor market in order to promote the so-called "*Flexicurity"* (flexibility does not necessarily lead to insecurity); reform the tax system; align the national pension systems to the national demographic situation; and finally, include some form of debt-brakes through domestic tax law (Altomonte et al., 2011, pp. 10-11).

Since the launch of the euro, the broadest strengthening of the European governance is represented by the so called “Six Pack” (Forte, 2010). In concrete terms, it is a legislative package which consists of six measures. Four of them concern the '*multilateral surveillance'* of Member States’ budgets, with an empowerment of both, the preventive and corrective phases of the *'Stability Pact'*, and with a new procedure which aims to reduce not only the excessive deficits, but also public debts. The remaining two have the scope to identify and correct excessive 'macroeconomic imbalances' in the euro zone. One of the most relevant aspects of the “*Six Pack”* concerns new excessive debt procedures, under which the evolution of accumulated public debt will be followed and treated in the same manner as the evolution of annual deficit.

All countries which have a debt ratio of over 60% will be required to gradually reduce it to an annual rate equal to one-twentieth of the excess amount. In addition, there are new financial

[3] For further information on gov. reform: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf
[4] GU 2011, L 91, pag. 2.: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:091:0001:0002:IT:PDF

sanctions against euro zone countries which do not implement a sound fiscal policy, or do not meet the agreed consolidation. In the *preventive phase*, these countries will have to constitute an interest-bearing deposit equal to 0.2% of GDP, while during the next *corrective phase*, the same deposit will become non-bearing, and then possibly converted into a fine, if these countries do not observe the recommendation regarding the corrections of the budget.

In this regard, it should be pointed out that the new mechanism based on "*reverse qualified majority*", by which sanctions are imposed for non-compliant countries, is a semi-automatic procedure, whereby the Commission proposal will be adopted unless it is *rejected* by a *qualified majority* in the *Council.*

By contrast, the new procedures regarding the macroeconomic imbalances require a risk assessment carried out at regular intervals which is based on a "benchmarking' composed of economic indicators. Subsequently, based on the evaluation results, the Commission is proposing to the Council to adopt recommendations, and to initiate a "procedure for excessive imbalances" for Member States which fail to comply with the obligations. If a euro zone state does not observe the recommendations of the EU Council, it will be obliged to pay an interest-bearing deposit of an amount up to 0.1% of its GDP.

It's important to specify that the euro zone countries which provide false statistics regarding the amount of theirs budget deficit and public debt will be punished with a fine equal to 0.2% of GDP (Altomonte et al., 2011, pp. 11-12).

In order to strengthen and deepen the coordination of economic policies between Member States, a new multilateral budget surveillance requests that the objectives of public finance and economic policies of each country, be sent to the Commission for evaluation before their effective implementation.

After witnessing the rise of market tensions, the European authorities agreed to establish a temporary crisis management mechanism which is to consist of two instruments. The first is called the European Financial Stabilization Mechanism (EFSM),[5] and provides the lending services up to a maximum of $ 60 billion. The other instrument, the European Financial Stability Facility (EFSF)[6], consists of a special purpose vehicle which would raise funds in the markets by taking advantage of the guarantee offered by the euro zone countries for a maximum of one thousand billion.
In order to access these funds in the form of loans, the applicant states will be obliged to pursue greater budgetary discipline, and to comply with certain guidelines of the economic policy.

In addition to the established temporary mechanism, the European authorities are convinced with the need to create a permanent mechanism which would safeguard the stability of the euro *area financial system*. This mechanism, called the European Stability Mechanism (ESM), is expected to enter into force once the EFSF comes to an end, (i.e. in 2013), and will have a financial capability of more than 500 billion euros. Despite all of these efforts aimed at achieving sound public finances, and ensuring financial stability in the euro area, it remains necessary to implement targeted growth policies which are essential for the achievement of those goals.

4. Can a fiscal union be the solution for euro crisis?

The adherence to a monetary union involves certain costs, but also has several benefits for member countries. The costs are primarily attributable to the surrender of monetary sovereignty and to the inability to use the exchange rate to curb any idiosyncratic shocks. Instead, the benefits from the creation of a monetary union can be both microeconomic and macroeconomic. With regards to the first, they mainly consist of increased efficiency, achieved due to the elimination of exchange rate risk and transaction costs, as well as greater price transparency. Among the

[5] For further information on EFSM: http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm
[6] For further information on EFSF: http://www.efsf.europa.eu/about/index.htm

most relevant macroeconomic benefits are higher currency international appeal and greater monetary stability.

The theory of optimum currency areas (OCA) will now be applied in order to better analyze the effects of a possible fiscal unification between the euro zone countries[7]. According to the theory, an OCA has to be distinguished by: labor mobility (defined by Mundell), diversification of production (Kenen), openness to international trade (McKinnon); and fiscal transfers, homogeneity of preferences including solidarity criteria (Baldwin & Wyplosz, 2009, pp. 378-392).

On the basis of these criteria, the euro zone cannot yet be considered an optimum currency area as it fails to meet a) Labour Mobility and b) Fiscal Transfers. In fact, while responsibility for monetary policy was transferred to the supranational institution, the European Central Bank (ECB), *fiscal policy remains* the remit of each *individual* EU *Member State*. These countries can delegate some of the powers to the regional or sub-regional levels, and they are bound only to the limits of 3 % deficit / GDP and 60% of the public debt / GDP, set in the Maastricht Treaty and reaffirmed later in the Stability and Growth Pact. As for the rest, no other community legislation of this magnitude regarding fiscal policy exists, nor a central European authority which would have competence in this area. Considering the fact that fiscal policy, as opposed to monetary policy is not centralized, it is impossible to make even fiscal transfers between the euro zone countries. As a result, the lack of a single budget policy seems to hinder the existence of an OCA in the euro area and consequently, its benefits. For these reasons, 25 EU member states decided to sign this year the Treaty on Stability, Coordination and Governance, also known as the Fiscal Compact. The treaty defines a balanced budget as one which has a general budget deficit less than 3% of GDP and a structural deficit of less than either 0.5% or 1%, depending on a countries debt-to-GDP ratio. If the structural deficit for the annual account or budget is found to exceed these limits, the country will have to correct the issue within the timeline, nature and targeted size deemed as necessary by the European Commission. Nevertheless, it is feared that in a context characterized by low labor mobility and the rigidity of prices and wages, it could become difficult to cope with asymmetric shocks which, in the absence of fiscal transfers, may lead to a decrease in the levels of production and employment.

Any central budget would allow automatic transfers, thereby alleviating the social costs of the monetary union. If the centralization of budgets is not possible, then countries should be permitted to use the fiscal policy with more flexibility. In other words, they should be allowed to increase deficit spending through specific budget stabilizers in order to contain the negative impacts resulting from asymmetric shocks.

While fiscal unification, under supranational authority able to make fiscal transfers between different states, could strengthen the European monetary integration, it could also make it even weaker. It should be noted that fiscal policy instruments in accordance with EU law, and essential for making the euro area into an OCA, are not feasible. In particular, the "no bailout clause", enshrined in the Treaty of Maastricht[8], prohibits member countries from assuming debts of other countries and from transferring resources to repay them. Thus, implementing the fiscal transfer criteria would be impractical. The only significant advances made thus far towards the unification of fiscal policies do not allow for the flexibility of fiscal policies, which are instrumental to mitigate the social costs caused by asymmetric shocks in the Economic and Monetary Union.

The possible overrun of these limits cannot be resolved through an intervention by the ECB, as its own statute prohibits the direct financing of governments. There is fear of moral hazard as the ECB's involvement would create the incentive for governments to follow deficit spending with the expectation that it could be financed with some form of inflation tax. In any case, it

[7] An optimum currency area (OCA) is a geographical region in which it would maximize economic efficiency to have the entire region share a single currency.

[8] For further information on the Treaty of Maastricht: http://eur-lex.europa.eu/it/treaties/dat/11992M/htm/11992M.html

is not to be taken for granted that any changes to these regulations would certainly have positive impacts on the euro zone countries and therefore on the existence of the single currency itself.

According to Alberto Bisin (2011), a fiscal union would indeed make the less rich areas dependent on the most prosperous and dynamic ones within the euro zone. The experiences of countries such as Belgium, reveal the immense difficulty of avoiding self-perpetuating transfers over time, because they generate negative impacts on mobility. In addition, transfers often hinder the convergence not only of growth rates, but also of the public expenditure rates. Finally, the fiscal union would reduce the political responsibility of member countries as it would inhibit the fiscal competition which seems to be a more efficient form of divergence reduction as opposed to fiscal transfers.

A greater centralization of fiscal policy would cause, through these channels, negative repercussions for the economic and monetary union. An alternative solution could be represented by fiscal federalism, namely the sharing of responsibility for the fiscal policy among member states and the central European institutions. These responsibilities could be shared through coordination between EU countries or delegation of specific tasks to supranational institutions; the last option would mean a partial renunciation of national sovereignty. The sharing of prerogatives would counteract the negative externalities of states' independent actions, allowing them to exploit the increasing returns to scale (IRS) resulting from the implementation of common policies; in both cases there is a net efficiency gain.

However, the heterogeneity of preferences and information asymmetry discourage the sharing of supranational fiscal policy decisions. According to some scholars such as Frankel and Rose (1997), who place the emphasis on the so called "endogeneity of process"[9], the introduction of a single currency would trigger internal changes which would make the currency area an optimal one over time, without a need for fiscal transfers or any other requirements. From this point of view, there is no need for fiscal unification as the process of consolidation of the monetary union would become self-perpetuating.

5. Conclusion

Thus far, not enough has been done in the process of European fiscal unification, at least in comparison to the monetary integration which can be considered completed with the adoption of the euro and the single monetary policy. It is quite difficult to determine if and how to proceed towards the unification of fiscal policies, as the creation of rules that allow fiscal transfers among the euro area members can have both positive and negative impacts on the Economic and Monetary Union (EMU).

Moreover, even the hypothesis of fiscal federalism has at the same time several advantages and disadvantages. In 1969, the economist Kenen (1969, p. 45) wrote: "... *monetary policy and fiscal policy must go hand in hand, and for the presence of an optimal combination of the two, it is necessary that they have the same domain. The single Treasury, in collaboration or in competition with the Central Bank, should have absolute control over public spending and taxation decisions*". A centralized supranational coordination of the monetary and fiscal policies faces, however, a major obstacle. It is very difficult, if not impossible to create a properly functioning central independent authority such as the ECB, which would have exclusive competence in the field of fiscal policy. Nonetheless, a greater centralization of fiscal policies should have been considered, because the common rules concerning the sovereign debt and deficit (under the Maastricht Treaty and the Stability and Growth Pact) have undoubtedly contributed to greater fiscal discipline of governments. Furthermore, a closer coordination and greater oversight of national fiscal policies at the EU level, seems increasingly necessary in order to deal with the current euro zone debt crisis.

[9] The endogeneity of the requirements are not referring to those of Mundell, 1961, or any other classic works on the optimum currency areas (McKinnon 1963, Kenen, 1969) but those on trade intensity and synchronization or correlation of cyclic profiles.

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