Can the Euro Pact Foster Convergence and Enhance Growth? A View from a Non-Eurozone EU Country+

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Introductory remarks

The sovereign debt crisis has created enormous anguish in the EMU and emergency measures continue to be used at a time when a sort of economic recovery seems to be under way. The European Council summit of October 2010 considered a Task Force report with a telling name: "Strengthening economic governance in the EU". This document is to be examined in conjunction with the governance reform proposals issued by the European Commission and related documents. In March 2011, the Council adopted the Euro Pact. But this demarche is not an attempt to explore a terra incognita. From the very beginning of the European Monetary Union (EMU) there was some discomfort with its institutional underpinnings and there were misgivings regarding its optimality as a currency area. This explains why a train of thought underlines a political rationale, too, for the creation of the EMU. Likewise, criticism over the way regulation and supervision were established in the Union is not of recent vintage. And insufficiencies of the Stability and Growth Pact (SGP), with almost all member states flouting its rules at various points in time, were repeatedly pointed out. This said, however, the flaws of financial intermediation have been less tackled by policy-makers and central bankers for reasons which, partially, are to be found in a paradigm which has dominated economic thinking in recent decades. This paper focuses on roots of the huge strain in the EU (EMU) and policy issues ensuing from the current crisis. It also looks at the stake NMSs have in a reformed EU economic governance structure. Nota Bene: there is a "political reality" which constrains decisions in the EU; the latter is not a federal state and what appears to be rational when defined strictly economically may clash with implications of the political configuration of the Union.

1. Structural Rifts in the EU Architecture

1.1 Weaknesses of the EMU

The severity of the current financial crisis has tested the very foundations of the European Union (EU) structure The current crisis has highlighted the inadequacy of existing institutional and policy arrangements at the EU level. Even before the crisis EU economic growth was weak by international standards, revealing deep structural problems across EU countries. Macroeconomic imbalances have been building up, exposing a stratified EU with divergences in productivity and competitiveness, with rigidity in labor markets impeding efficient market responses to negative shocks.

Fiscal discipline has also been slow to enforce, even from the birth of the EMU. Greece, for instance, was allowed to join the euro area although it was in clear violation of the criterion that public debt must be less than 60% of GDP (IMF 2004). What is more astonishing is that its budget deficits have never been below the Maastricht criterion of 3% of GDP since 1997. Several other EU countries have also been in frequent breach of the Maastricht criteria and failed to meet the requirements of the Stability and Growth Pact (SGP).

Moreover, the monetary policy pursued by the European Central Bank (ECB) proved to be too loose for peripheral countries, facilitating the emergence of market disequilibria. The "one size fits all" monetary policy of the ECB could not prevent excessive capital, frequently of a speculative nature, flowing into less developed areas of the EMU and in the EU as a whole. The European cross-border nature of financial entities has left them exposed to each other while burden-sharing arrangements in case of a failed entity were missing. Systemic risks, which have been engendered by "too big to fail" cases, have been compounded by effects of a "too big to be saved" syndrome.

In Europe, integration, with its financial component, was seen as a principal way to achieve catching up. But, in spite of massive cross border operations taking place across EU, national prerogatives on regulation and supervision remain virtually a domestic issue. In addition, the EMU is still far away from an optimal currency area. All these drawbacks reinforce the need for deep reforms of the EU governance structure. It is the heterogeneity of the EU, which requires these changes.

In the case of New Member States (NMSs) macroeconomic disequilibria in asset markets emerged following investment in non-tradable goods sectors. FDIs have tried, to a large extent, to exploit arbitrage opportunities by investing in activities with small capital requirements and/or large profits. Inadequate regulatory and supervisory arrangements operate in this case, too, in view of the size of cross-border financial flows and the domination of local markets by foreign banks.

1.2 Faults in the Financial System

The current crisis has exposed flaws in the working of financial markets. Macro-economic policy errors were exacerbated by blatant abuses brought about by the securitization process, excessive leverage and perverse incentives. The use of inadequate risk-assessment models together with failures to check for systemic risks compounded the problems.

Financial intermediation, as it has evolved during the past decades, has spurred financial innovation. However, it has also increased the opaqueness of markets due to securitization and off balance sheet activity. The financial industry has become oversized in a number of economies, highlighting the global perils of systemic risks. Networks seldom emerge accidentally; they also tend to be shaped by policies. As Haldane, the director of research at the Bank of England noted: "Deregulation swept aside banking segregation and, with it, decomposability of the financial network. The upshot was a predictable lack of network robustness..." (p. 31).

Prior to the financial crisis the European leaders failed to recognize the extent to which European banks were involved in the origination and distribution of toxic financial products. Financial sector practices have also obscured the size and dangers of the shadow-banking sector in Europe. The distribution of responsibilities between home and host country and the inexistence of detailed burden-sharing arrangements in the event of a crisis has been a major handicap for the single market under conditions of deep financial integration[1]. Under current arrangements, responsibility for the stability of financial institutions belongs to the supervisor of the country where they are headquartered whereas responsibility for the stability of financial systems belongs to the supervisor of the host country. This crisis reinforces the idea that a common rulebook, more integrated supervision, and a common framework for crisis resolution are all needed to match the degree of financial integration. On the other hand, the burden-sharing issue prompts national governments and supervisors to think more along national lines, in view of their accountability toward national taxpayers.

1.3 The EU Failures in a Coordinated Policy Design

In the face of crises the European institutions have almost always had a reactive approach, doing just enough to fix the problem in the short term. At the root of this cause are conflicting national interests and inadequate institutional arrangements. The two previous notable European initiatives, the Lisbon Strategy and the SGP have both failed because rules enforcement was weak, not to say largely inadequate. With domestic interests at stake, peer governments loathed penalizing each other. Proposals of automatic sanctions, triggered in the event of breaching the rules, have been consistently ignored. Another reason why those initiatives failed is because they minimized the role of major discrepancies among member countries at various levels: structural, economic and political and the cost incurred to fulfill the stated objectives.

The Europe 2020 Agenda aims at making up for past policy mistakes. In a global space where competition takes place, frequently, via zero-sum games, the EU economy has been consistently losing ground over the last decade. Although national policies do make a difference, the issue goes deeper than economics and concerns the whole range of values and norms embraced by a particular society.

2. The EU Policy Response; the Euro Plus Pact (EPP)

The EU policy response to the financial and economic crisis has two components:

- A crisis management undertaking, which has tried to curb the economic downturn and avert a financial meltdown. The ECB has taken an active role in this, which has gone much beyond its usual mandate
- Measures aimed at reforming the EU’s economic governance. This component is multi-faced and, as it has been discussed at the meeting of the EU leaders at the end of March 2011, has several aims, namely:
    - Fiscal consolidation by addressing the sustainability of pensions, health care and social benefits together with the adoption of national fiscal rules.
    - Growth-enhancing structural reforms through higher employment and competitiveness
    - The reform of the regulation and supervision of financial markets and restore the health to the financial sector.
    - The set up of a permanent lending facility in the euro area

[1]As the de Larosiere report notes, ‘The absence of a sound framework for crisis management and resolution (with sufficiently clear principles on burden sharing, customers’ protection, assets transferability and winding up) complicates the introduction of an effective and efficient supervisory system to avoid financial crises in the first place’ (p. 76).

The proposals package is expected to be adopted by the European Parliament by June 2011. The first three directions mentioned above form the object of the EPP[2], which has already been agreed by the euro area heads of state jointly with several non-member states[3]. Under the EPP proposals, each individual country would be responsible for the specific action it would choose to implement in achieving the commonly agreed objectives, monitored through a set of economic indicators. From a normative point of view the proposed measures could be seen as a step forward in improving the functioning of the euro currency area. But, big challenges remain. These relate to the implementation, coordination and enforcement of these measures as well as to filling in the gaps of the existing agreement.

For the NMSs there are, *arguably*, advantages in joining the EPP. First, it is this group of countries which would benefit the most provided effective policies are pursued, at the EU level, that increase convergence. Second, most of these countries are already implementing structural reforms aimed at achieving fiscal consolidation and making labor markets more flexible. Third, some sort of supra-national governance is likely to be beneficial in countries with weak domestic institutions, which prevent them from implementing sound policies. But things are much more complicated when all implications of the EPP are considered and judgments need to be nuanced.

2.1 Fiscal Consolidation

The EU's sovereign debt crises, which ensued from the financial and economic crisis, have heightened concerns for *fiscal sustainability*. Governments' responses during this crisis and in other crises episodes show that, avoiding a systemic collapse necessarily entails burdening public debt. Thus, the policy of strengthened fiscal discipline should be seen in conjunction with policies addressing macroeconomic imbalances in the EU. A stronger SGP will be strengthened by improved surveillance and better data quality gathered from EU member states. The new system would rely on a much stronger compliance regime via "financial and reputational sanctions". The introduction of fiscal rules, as set out in the SGP, in national legislation is expected to enforce compliance with the SGP rules – which have been so often broken in the past.

The *preventive arm* of the SGP considers the sustainability of overall public debt, while the corrective arm targets a budget deficit path, which should bring down the debt to GDP ratio over time, in a consistent manner. The preventive component of SGP will limit public spending growth below the medium-term GDP growth until the target is met. It will also require that ''best practice'' budgetary procedures are implemented i.e. the adoption of multi-year budget planning, overview of fiscal targets by independent fiscal councils, the implementation of fiscal rules and increased transparency in statistics. These are useful innovations, which are likely to strengthen the preventive arm of the SGP.

However, there are changes to the corrective arm of the SGP, which would prove to be more challenging to implement in practice. The modification of the corrective component of SGP envisages the introduction of a 60% of GDP target for public debt, in addition to the 3% of GDP deficit limit. And, if public debt exceeded 60% of GDP, the country would be forced to bring it down at a pace of one twentieth of the excess over the previous three years[4]. These changes could raise several problems in practice:

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[2] The EPP is viewed by many as reflecting, basically, a Berlin view, but it also relies on proposals made by the European Commission and the task force headed by the president of the European Council, Herman van Rompuy.

[3] These are Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. Hungary, the Czech Republic, Sweden and the United Kingdom decided to opt out from the EPP.

[4] A breach of either the deficit or debt limits would trigger an infringement procedure and a fine of 0.2% of GDP if the country fails to comply. Rejecting a penalty proposed by the Commission would need a qualified majority in the Council of Ministers, i.e. by ''reversal voting''. ''Excessive

- Requiring a country to bring down its public debt during recession may be self- defeating, owing to the pro-cyclical nature of debt to GDP ratios.
- Since debt ratios are above 60% of GDP in most EU countries, collective action in reducing public debt could have a negative impact on the whole EU economic growth.
- Meeting the objectives of the revised SGP in the absence of a workable framework for bank debt resolution and recapitalization could be challenging for all EU members. Both targets could be easily overshot in circumstances when some private institutions, deemed too big to fail, would need to be bailed out by national governments.
- Countries with high debt/GDP ratio could face credibility problems in meeting the targets at the required speed, as their policies would face serious economic and social constraints. This could impact their borrowing costs for a long time, hampering their fiscal adjustment program.
- The EC's penalty system might not be credible as some of the indicators monitored are not policy variables and thus cannot be controlled by government policy (Manasse Paolo 2010).

The EPP places a disproportionate weight on fiscal adjustment issues. But, fiscal indiscipline was not a cause of the crises in Ireland or Spain, for instance. Moreover, the risk of almost all EU countries behaving the same, i.e. enforcing the Maastricht criteria on public debt and deficit, could have a powerful recessionary bias in Europe.

Except Hungary, NMSs do not have large public debts. But budget deficits have gone up dramatically in the wake of this crisis. Moreover, not a few NMSs were running meaningful structural deficits prior to the crisis, based on their existing economic growth model at the time. Consequently, the Baltic countries, Bulgaria and Romania have had to implement their fiscal consolidation programs because of the permanent loss of output and impairment of economic growth --against the backdrop of a highly unfriendly external environment that has been entailed by the turmoil in financial markets. But, as Becker et all (2011) note, fiscal consolidation has to take into account the risk of adding public deleveraging to the ongoing private deleveraging, a factor which could harm economic recovery.

NMSs would benefit hugely from a high degree of absorption of EU structural and cohesion funds. These resources would offset the influence of expenditure reduction on aggregate economic activity while giving a boost to public investment in a period of economic distress. The availability of these resources would help prevent fiscal consolidation becoming pro-cyclical during a recession. The IFIs and EU supported adjustment programs in NMSs have, arguably, not paid sufficient attention to the strategic role of EU structural and cohesion funds in this new context.

For NMSs the introduction of fiscal rules is desirable, as it would discipline fiscal policy and remove, to a great extent, the influences of political business cycle on the economy. But, the limitation of budget deficit at 3% of GDP could be a serious constraint at times, given the nature of mandatory expenditure. For instance, it matters a great deal how contributions made to private pensions schemes, which are part of the pension system reform, are accounted for in the measurement of the structural budget deficit. The risk is that such legislative changes could be reversed in extreme circumstances if the degree of public endurance with fiscal reforms wears thin.

2.2 Implement growth-enhancing structural reforms

The EPP proposes two main areas where improvements could be made: labor market and competitiveness. It has to be noted that the same areas were singled out in need of enhancement in the Lisbon 2010 Treaty. However, progress in achieving those

imbalances'' of other economic indicators trigger a 0.1% of GDP penalty.

objectives was only marginal at best, in most of the EU economies. The new proposals aim at remedying this. But, in practice they could raise more problems and lead to growing discrepancies among EU economies.

2.2.1 Increasing Competitiveness

The EPP suggests assessing wage and productivity developments by looking at relative unit labor costs (ULC) in euro area countries and their trading partners. Imbalances between costs and productivity are supposed to be resolved through wage control growth, product market liberalization, improvement in R&D, infrastructure and innovation as well as the business environment.

There are problems with the way in which proposals have been made. First, the one-size-fit-all logic applied across EU countries could have unintended consequences. Witness the effects that a single monetary policy had on EU peripheral economies during the boom years. Then, economies such as Spain or Ireland could have done with a much higher level of interest rates in order to prevent domestic macroeconomic imbalances building up. The same reasoning applies to the stated objectives of EPP on competitiveness. Initial conditions do matter and, an attempt to somehow correlate unit labor costs[5] across EU member states using current indicators as benchmarks, have the potential to lead to more destabilizing conditions in the future. Besides, economic growth is likely to slow further following the introduction of these measures, at a time when growth pick up is paramount for the success of country stabilization programs.

Second, competitiveness is not a policy instrument, and it cannot be influenced unambiguously and directly by governments' economic policy. The authorities could strive to create the premises for an economy to develop but the ultimate outcome is a complex result of a market given context. NMSs, for instance, have traditionally benefited from lower labor costs but other factors such as inappropriate physical and skilled human capital in various sectors, or a low level of R&D impact adversely on their long-term competitiveness. Moreover, building up higher stocks of capital takes time and entails fast economic growth rates. For most NMSs a major policy issue is how to enhance resource allocation toward tradable sectors. For this crisis has revealed flaws of the precrisis growth model.

Not least, the focus on ULC as a measure of a country's competitiveness might be seriously misleading. Felipe and Kumar (2011) suggest that there are conceptual problems with it. If ULC are considered, then unit capital cost (UCC), that is the ratio of profits to capital productivity, would also be looked at. The authors show that capital productivity has been displaying a declining trend in the EU. Moreover, a ULC for tradable goods comparison across EU countries could be misleading because of the complexities of export products, which vary across the EU economies. NMSs tend to export lower value added and lower technology products while Germany; for example, exports over 12% of the world's top 10 most complex products. Thus, if Germany were supposed to provide a benchmark for competitive policies in the EU, based on ULC, it would in fact distort the whole picture and impose unfounded constraints on NMS' policies.

There would also be major implications for national policies, which are asked to undertake corrective measures. Governments could become more involved in the management of the economy, in mediating between social partners for the sake of achieving competitiveness targets. And as competitive devaluation can be damaging

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[5] There are various measures of competitiveness indicators, which often yield different results. Although proposals by the EPP suggest a range of ULC indicators to be used for various sectors of the economy, these still remain just one measure of competitiveness – most likely chosen because they facilitate comparisons across EU countries on a similar basis.

overall the same could happen with “competitive” wage controls throughout the EU.

2.2.2 Fostering Employment

The EPP suggests each national state would have to implement policies aimed at increasing participation rate, lowering labor tax rates or increase lifelong learning. While from a normative point of view such policies are desirable, their pursuance might yield the expected outcome in the long term only. The labor market is far from being flexible across EU countries. Apart from labor market restrictions – which still apply to some NMSs such as Romania or Bulgaria, five years after they joined the EU – labor mobility within the EU remains low compared to the US for instance. Citizens of NMSs face relatively high migration costs, given their earning power. A uniform labor market reform across EU economies could have asymmetric effects as labor, being mobile, could shift towards most developed economies where wages are much higher. The richer EU countries are also devising means to attract highly skilled labor from poorer countries.

2.3 Financial Sector’s Regulation and Supervision Reform

European policy-makers are advancing with an overhaul of the regulatory and supervisory structures of financial systems, including the parallel banking sector and rating agencies. Harmonization of rules is not a sufficient response to the crisis, since the very content of regulations and supervision needs radical change[6]. A reformed regulatory and supervisory framework would observe basic principles such as regulation of all financial entities (including the *shadow banking sector, hedge funds and private equity funds*), higher capital and liquidity adequacy ratios, capping leverage, bringing derivatives into the open and having their trading regulated, preventing regulatory arbitrage, transparent accounting rules, and addressing systemic risk.

The EPP would impose proper bank stress tests together with close monitoring of private debt for banks, households and non-financial firms.

In the EU there is need to strengthen the regulation and supervision of major financial groups, which operate cross-border. The European Systemic Risk Board (ESRB) together with the new supervisory authorities should bring a decisive plus in this regard. The ESRB should intervene whenever credit expansion is threatening the stability of one or several of the EU member economies. In April 2011 Britain’s Independent Banking Commission released its interim report, which suggested that the financial system would be more resilient to future crises if banks’ retail were ring-fenced as against investment units. But this proposal comes short of the proposal put forward by Paul Volker, the former Federal Reserve Chairman, which suggested a complete separation between the two bank activities, as they were prior to the abrogation of the Glass-Steagall Act of 1933. As a matter of fact, the “too big to fail” issue is still unaddressed by policy-makers and, ironically, the unfolding of the financial crisis has resulted in bank consolidation, which entails a heightened moral hazard problem (Johnson, 2010)[7]. Global competition and the fear of regulatory arbitrage are not peremptory arguments in this respect. The persistence of this problem rather reflects the power of vested interest.

The current global crisis has triggered an unprecedented response from governments. But, one large component of this response, namely consistent public sector bailouts of the private sector, notably of the banking sector, continues to pose more

[6] This is what comes out prominently from the de Larosiere report and the Turner report (in the UK), from documents of the European Parliament and directives of the European Commission, the Monti Report, etc.

[7] As put by Goldstein and Veron this issue is more challenging in Europe owing to a higher concentration of banking markets (than in the US), general reluctance to let banks fail, the interdependence between banking and political systems and, not least, nationalism (2011).

questions than it solves. The cross border structure of European bank operations and the years of resource misallocation have left many banks in Germany, France or Austria with a heavy exposure to peripheral EU countries and NMSs, i.e. those countries which now undergo painful adjustment programs. There is now a vicious circle emerging in which the refinancing of debt from countries with lower credit ratings is being done indirectly by those euro area member countries which have a solid interest in protecting the health of their national commercial banks' balance sheets. But the onus of adjustment is almost entirely put on the taxpayers of the countries in distress, which raises a host of practical and moral issues. A legitimate question therefore arises: is such an arrangement appropriate and sustainable (does it take into account the need for burden-sharing[8]?).

There is a view that stress tests performed across European banks fail to incorporate extreme scenarios, such as default by a member state, simply because such a default is perceived to be politically inconceivable and would trigger powerful contagion effects. But this is likely, under some extreme scenarios, to merely postpone an outcome which is widely expected by markets, namely sovereign debt restructuring. With banks from peripheral Europe being currently dependent on ECB financing, the price mechanism of sovereign debt of distressed countries is distorted. This is not likely to mitigate contagion fears and would also affect borrowing costs for lower rated EU countries. The situation could persist for years if economic growth in the EU fails to materialize or the speed of the planned reforms slows down. Moreover, the problem is to be compounded in the future if interest rates rose[9] and protectionist measures were to take hold.

The EU could acknowledge an insolvency problem and come up with some form of debt restructuring for distressed sovereigns whose public debt is on an unsustainable path[10].; it would imply a restructuring or even closing down insolvent European banks[11]. This option would also go some way in addressing the so-called 'burden sharing' issue among EU countries, since it was the banks from creditor EU members which provided loans that subsequently turned bad, in the first place[12]. However, such an action asks for a political decision in the EU donor countries, in Germany in particular, which is hardly feasible under current circumstances[13]. In addition, sovereign debt restructuring[14], however orderly it can be, may not prevent contagion, which would have its cost open-

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[8] Burden sharing can be seen through two pair of lenses. One regards whether private investors (bond-holders) share into the costs of debt restructuring. The other one refers to the distribution of costs among EU member countries. Thence arises the political sensitivity of this issue. Both perspectives imply the impact of an eventual sovereign debt restructuring on banks' balance sheets.

[9] The rise in the policy rate of the ECB of March 2011 finds justification in inflationary pressures in the euro area. But these pressures are due to imported inflation essentially, not to higher demand (see also Stephen King). Moreover, higher interest rates would harm the economies, particularly those which go through very difficult adjustment programs.

[10] The prevailing common view at various EU institutions, including the ECB, is that a country, which commits itself to a credible adjustment program, cannot be considered insolvent and thus should not be placed in a position to restructure its debt. What the ECB seems to fear mostly is contagion brought about by a sovereign debt restructuring, be it done in an orderly manner.

[11] See also Darvas, Pisani Ferry and Sapir (2011)

[12] The possibility of adoption of collective action clauses (implying *haircuts*) by euro-area members, involving agreements between debtors and creditors over debt restructuring, has been explored at the European level (see Bini Smaghi, 2010)

[13] For the political and social climate, which goes against such a solution, see also Guerot and Leonard (2011). The spectacular political advance of the "True Finns Party" in Finland speaks volumes about the contradiction between economic logic and political reality.

[14] Debt restructuring distinguishes between reprofiling of bonds, with their maturity extended, and write-downs (haircuts) on the value of the debt. The latter would impact significantly on not a few banks' balance sheets, which would need recapitalization.

ended. This is, arguably, what the ECB and donor countries fear mostly in rushing things[15]. But putting off the day of reckoning may not be less costly. The crux of the matter seems to be how to make private investors accept haircuts while reopening financial markets to the countries in financial distress by making their adjustment programs as credible as possible; it like a catch-22 dilemma.

2.4. A Mechanism for Crisis Resolution

The sovereign debt crisis in the euro area exposed the incompleteness of the EMU policy framework. The agreement to create the European Stability Mechanism (ESM) from June 2013 thus answers a necessity. From its inception, in June 2013, the ESM will replace the current existing mechanism, the European Financial Stability Mechanism (EFSM) with the objective of providing financial assistance to euro-area member states under strict policy conditionality. The ESM will also have a larger lending capacity, of Euro 500 Bn. There are several issues to be noted about the ESM.

First, there is the issue of the individual member contribution to the ESM capital structure. Countries with lower credit ratings will end up paying up more to the ESM capital.

Second, questions are raised over the perceived limited lending capacity of both EFSM and ESM. With Portugal being the third country, which asked for financial assistance in April 2011, the pressure could now move on to Spain and Italy if further political and economic negative shocks materialize. Under this scenario the existing EFSM lending capacity would be strained beyond the current limit.

Third, the mechanism by which a loan guarantee is triggered in ESM could place sudden pressures on domestic budgets in member countries, worsening their budgetary positions unexpectedly.

The EFSM should be complemented by an effective framework for bank debt resolution and recapitalization. This could prevent an Irish type contagion from bank to sovereign debt to become the norm in other EU countries. There is a view which holds that the proposed sovereign debt default mechanism will make the EMU more prone to crises since it will introduce speculative dynamics into it, and an analogy is made with the Exchange Rate Mechanism (ERM) that preceded the start of the Eurozone (de Grauwe, b). A related problem is that the ESM could bring about another inconsistency, namely: the possibility of default, persistent imbalances and lack of proper fiscal arrangements (Munchau). This brings us back to square one, namely, the possibility of having a monetary union without solid fiscal (budget) underpinnings. Added to this is the need for real economic convergence in the EMU.

3. Issues Pertaining to NMSs

3.1 Financial stability in NMS[16]

Financial stability in NMSs relates to, on one hand, crisis management in the euro area and, on the other hand, to specific concerns. Crisis management in the euro area gives a very high profile to contagion. Let us keep in mind that financial markets in NMSs are heavily dominated by foreign groups and their economies are significantly 'euro'-ised. For instance, Greek banks play a sizeable role in South Eastern Europe. An eventual restructuring of Greece's sovereign debt, unless it is done properly, could have a very serious impact on neighboring financial markets. For this reason the home-country authorities have to work very closely with host-country authorities and the ECB should cases of bank distress appear. It would be important for governors of the central banks

[15] Juergen Stark, a member of the ECB executive board, was quoted by Reuters (26th of April 2011) saying that a sovereign debt restructuring (he was referring to Greece) would be the equivalent of Lehman Brothers' fall for the euro area. See also Milne (2011)

[16] This section draws on "Whither growth in central and eastern Europe" (2010)

(representing the main regulatory/supervisory bodies) in the region to keep in close contact and coordinate their measures. A formal initiative would be more than welcome in this respect in which the ESRB should play a leading role.

There are several means to enhance access to liquidity and mitigate solvency threats at a supra-national level; many of remedies have been implemented during the crisis: rules on convergence of deposit guarantees, which should prevent beggar your neighbor policies; medium-term financial facilities; IFIs credit lines and investments. Two avenues to improve the EU's support to NMSs deserve discussion: swap lines between the ECB and central banks of non-euro area countries; a broadening of ECB range of accepted collaterals to national currency denominated bonds issues by non-euro NMS countries. These two measures, which would have helped to ward off euro liquidity shortages, were considered but not implemented at the height of the crisis.

Preventing credit booms will be an issue again in NMSs, sooner or later. Instruments that can be used are: counter-cyclical capital and reserve requirements; dynamic provisioning against expected losses; limits on leverage and maturity mismatches; discretionary macro- prudential measures under the guidance of newly created macro-prudential supervision bodies such as the European ESRB.

The difficulty for the NMSs is that this toolbox mostly applies to countries where credit is in the hands of national banks or autonomous local subsidiaries of foreign banks. It is not likely to be effective in countries where credit is mostly in the hands of foreign bank branches or lending can be outsourced to foreign entities of the banking group (i.e. the parent bank or a subsidiary in another country). Coordination among supervisors can be a response and should continue being developed but calling for coordination is no solution when institutions participating in it have different, possibly conflicting mandates and incentives. This is where the role of the ESRB comes prominently into the picture.

NMSs cannot rely on capital controls as the single market prohibits such measures[17]. Therefore, the risk of destabilizing capital inflows leading to credit bubbles has to be addressed through other means, which may include action on the demand for credit. Regulatory and tax instruments can for example be used to tame mortgage credit when deemed excessive from a macro- prudential point of view. All such measures, in order to be effective, would need to be adopted on a supra-national level.

3.2 Euro Adoption

The crisis in the euro area shows that removing the option of adjusting a nominal exchange rate may be very costly in terms of fiscal adjustment if it is not accompanied by efforts to limit excessive demand in the private sector, even if fiscal policy is broadly in order. However, limiting excess demand in the private sector is not easy to achieve for national governments that have surrendered their power over monetary policy in an environment with free capital mobility. It is noteworthy that housing and credit booms in Ireland and Spain, and in several NMS have been quite similar, suggesting that the fall in real interest rates as the result of financial integration and economic catching-up matters both inside and outside the euro area. Euro outsiders should therefore be careful before fixing the exchange rate and should allow as much flexibility as possible on the way to euro adoption; they, in any case, should introduce measures preventing the emergence of unsustainable credit booms. But host country authorities may not be effective in this effort because of deep financial integration. However, they are not completely impotent: measures such as dynamic provisioning, using loan-to-value ratios, increasing minimum reserve requirements can provide buffers against excesses.

[17] As some countries use waivers to restrict what they consider to be destabilizing labor inflows a similar logic could apply when EU countries are faced with destabilizing capital inflows. Tax tools could be used in order to diminish such inflows. Obviously, this would require a flexible interpretation of EU rules.

The crisis in the euro zone, in particular, the competitiveness problems of Spain, Portugal and Italy and the inability of these countries to adjust their competitiveness inside the euro area highlights a big policy issue: Should the criteria for the optimal currency area (OCA) be fulfilled *ex ante*, i.e. before a country enters the euro area, or is it sufficient to expect that they will be fulfilled *ex post*, i.e. euro admission will create structural changes in the economy that will make the country suitable to the monetary union, even if it had not been before? The inability of southern EMU countries to adjust to competitiveness pressures inside the Eurozone suggests that it would be better for euro newcomers if OCA criteria are satisfied *ex ante* and there are policy instruments to guide the eventual need to adjust real exchange rate divergences *ex post*.

The NMSs form a multi-colored cluster; some of them are better integrated in EU industrial networks and show balanced trade accounts, while others (including Romania) have skewed trade imbalances and much of capital inflows went into non-tradable sectors. Therefore, their chances of joining EMU are not similar.

3.3 Tax Harmonization Across the EU

One proposal of the EPP is for the EU members to explore the opportunity for tax harmonization. Agreeing to corporate tax harmonization across EPP countries, for instance, would go against the competitiveness concept. Removing incentives based on different taxation systems would be a major setback for less developed EU countries, such as NMS, in their efforts to attract investment. Tax competition policies are an important instrument in countries, which are involved in the catching-up process and thus need to build up capital because it is a useful tool in luring foreign investment.

3.4 The Threat of Low Equilibria and Pitfalls of a One Size Fits All Economic Policy

The current financial and economic crisis has revealed flaws of the growth model that depends on massive external borrowing and inattention paid to resource allocation. In some NMSs much of investment went into non-tradable sectors, which created the framework for unsustainable growth and hid structural budget deficits. Very painful corrections of imbalances are underway in several NMSs. These adjustments need to consider a changing international (European) context when it comes to credit terms, the flow of capital, trade competition, investing in education and, not least, the challenge of enhancing the growth of tradable sectors when national policy is constrained by the rules of the EU.

The euro pact brings novelties regarding fiscal discipline and policy coordination. But unless it pays thorough attention to the needs of emerging (low income) EU economies the latter may get stuck in low equilibria situations (Portugal's experience is quite relevant in this regard). EU funds absorption has to increase manifold in order to help develop their infrastructure, raise fixed capital investment in tradable sectors. Would foreign banks that operate in these countries change their lending proclivity and be more forward oriented as stakeholders? It is true that there is a sort of economic recovery in NMSs and some of them are bouncing back impressively by relying on exports. But sustainable high economic growth rates, liable to achieve convergence, ask for much more as a recipe for economic catching up. One should also bear in mind significant differences among NMSs; some of them (Czech Republic, Hungary, Slovakia, Poland) are better integrated in European industrial networks and perform better trade-wise.

The threat of being caught in a region of low equilibria has to be judged in conjunction with pitfalls of a one size fits all economic policy. For example, very low inflation (as Maastricht criteria demand) is pretty hard to obtain in an emerging economy[18]; it could even constrain growth. Or take the policy guideline of imposing

[18] Not least because of the Balassa-Samuelson effect and the prospects of further rises in the relative price of basic commodities (assuming that their consumption does no go down drastically)

limits to current account deficits (in the vicinity of 5% of GDP) in the countries that signed up to the EPP. If FDI is substantial and goes prevailingly into tradable sectors there should not cause much worry; in such a case a current account deficit which may go beyond 10% of GDP is not an unwelcome imbalance.

4. Other Issues To Ponder On

Disentangling private from public debt has become an overwhelming issue in the EU in view of its deep financial integration. Private sector (bank) debts are making up enormous contingent liabilities on public debts when bankruptcies are not tolerated (not to mention the moral hazard problem). This is one of the revelations entailed by the current crisis. And the inability to disentangle the myriad of intertwined debts will impact, negatively, on fiscal policies for years to come. Even now this feature of deep financial integration seems to be under-estimated by some. What is worrisome is that bank consolidation would preserve the hostage relationship governmental budgets are held into. Ways must be found to make sure that a golden rule of market economy operates, namely, that investors bear the risks they assume and losses are not socialized[19].

Fiscal rules, surveillance and peer pressure may not be enough for strengthening the cohesion of the EMU, of the EU in general. A handicap in the EU is linked with the political reality that taxpayers are, ultimately, national citizens. Can "common goods" (including the euro) be protected unless "common resources" (the EU budget?) are more substantial? Can resolution schemes and orderly restructuring schemes of sovereign debts be devised so that they compensate the smallness of the EU budget and complexity of the EU decision making process? Can the EU policy-makers use additional instruments in order to foster more real convergence in the EMU, in the EU as a whole? Is there room for strengthening policies at EU level?

Would a deflationary bias in the conduct of monetary policy appear in view of the willingness to prick bubbles in their infancy? On the other hand, would' n' it, by fostering less instability, support long-term growth? In a way, answering this question is analogous to deciding on a proper speed of implementing Basel III: for a too fast implementation could stifle recovery; on the other hand, a too slow implementation would create prerequisites for a new crisis.

Does size matter for judging fiscal risk? It appears it does. Large economies are, seemingly, considered to have a bigger capacity to resists shocks; they are, potentially, more resilient. Resilience (ability to withstand external and internal shocks) will increasingly be a principal policy aim in the years to come.

What would be the impact of new technology for circumventing rules (ex: high-frequency trading)? Regulators and supervisors need to take it into account as well, when thinking about financial stability. The latter can be linked also with the capacity of economy to withstand effects of natural disasters, with social strain. Demographics, too, play in a role when it perturbs inter-generational balance and, consequently, fiscal equilibria.

The years to come will quite likely be accompanied by an increasingly uncertain environment; complexity will also be on the rise. These circumstances advocate a more simple, resilient financial intermediation system, for the sake of its own stability. If this does not happen and global imbalances persist, more fragmentation is to be expected, with societies turning, probably, more inward looking. This will have profound implications for the global system. It may be that, in view of the lessons of financial crises and of the need to lend to economies more resilience, there is an optimal size of openness (trade and finance-wise). This implies that firms need to think globally and

[19] "…the current imperfect world where bondholders of banks and nations are shielded from suffering any pain cannot last. Something has to give"(Milne, 2011)

operate selectively as a means for mitigating risks[20]. It may also be the case that we will end up with a three blocs-based financial system as a means to maintain a relatively open global system (Daianu, 2009).

Final Remarks

Structure is key in understanding the roots of the current crisis and the tension in the EU (EMU). Such a perspective reinforces the rationale for a reform of the EU economic governance. As this crisis indicates it is not only fiscal rules and their compliance with that a proper functioning of the EMU hinges on. Flaws of financial intermediation, growing imbalances stemming from the dynamics of private sector saving and investment flows, inadequate regulation and supervision of financial markets, have played a major role in triggering the sovereign debt crisis in the EMU. The overexpansion of financial institutions and their investment behavior are to be highlighted as well. Consequently, a reform of the EU economic governance has to deal with fiscal rules and compliance, macroeconomic disequilibria and competitiveness gaps, the regulation and supervision of financial markets. The need to tackle global imbalances and overhaul international arrangements is to be mentioned in this context.

Fostering real economic convergence remains a huge challenge in the EMU, in the EU as a whole. The EU institutions and national governments need to address this issue more thoroughly. A threat for the EMU is a growing cleavage between its northern tier and its southern tier, with the latter becoming, possibly, mired into vicious circles, incapable of overcoming the impact of fiscal consolidation in a hostile external environment[21]. Another chasm could deepen between older EU member states and some NMSs. Can Europe 2020 provide a light in this regard? NMSs have a deep stake in EU governance reform since they cannot escape the impact of EU wide externalities and the functioning of their economies depends on the rules of the Union.

[20] Other catastrophic events (like the Fukushima disaster) highlight the risks of over-dependency on various sources of supply.

[21] A sort of "Mezzogiornification" of the South of the EMU, but with more tensions than those envisaged by Krugman (1993, p.80) and more threatening for the viability of the Union. See also Amato et.al (2010)

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