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The Euro Area Crisis Management Framework: Consequences for Convergence and Institutional Follow-ups

Ansgar Belke
University of Duisburg-Essen

Abstract

The current instruments in the EU to deal with debt and liquidity crises include the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). Both are temporary in nature (3 years). In terms of an efficient future crisis management framework one has to ask what follows after the EFSF and the EFSM expire in 3 years time. In this vein, this paper addresses the question of the political and economic medium- to longterm consequences of the recent decisions. Moreover, we assess what needs to be done using this window of opportunity of the coming 3 years. Which institutions need to be formalized, into what format, in order to achieve a coherent whole structure? This paper presents and evaluates alternatives as regards the on-going debate on establishing permanent instruments to support the stability of the euro. Among them are the enhancement of the effectiveness of the Stability and Growth Pact combined with the introduction of a "European semester" and a macroeconomic surveillance and crisis mechanism, fiscal limits hard-coded into each country's legislation in the form of automatic, binding and unchangeable rules and, as the preferred solution, the European Monetary Fund. Finally, it elucidates the political constraints of the ECB, assessing the EFSF and Eurobond solutions.

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*Corresponding address: Ansgar Belke; DIW Berlin and University of Duisburg-Essen, Department of Economics, 45117 Essen, Tel: +49 (0)201/183-2277, Fax: +49 (0)201/183-4181, E-mail: ansgar.belke@uni-due.de

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I. Introduction

In order to establish an excessive debt prevention and resolution mechanism for the euro area, a recent EU Commission communication on "Reinforcing economic policy coordination" states that "a clear and credible set of procedures for the provision of financial support to euro area member states in serious financial distress is necessary to preserve the financial stability of the euro area in the medium and long term" (European Commission 2010a).

The current EU instruments that address debt and liquidity crises include the European Financial Stability Facility (EFSF), the European Financial Stabilization Mechanism (EFSM), the European balance of payments instrument, and the European macro-financial assistance instrument. Of these, the EFSF and the EFSM are temporary in nature (three-year terms), and the other instruments do not apply to non-euro area member states. In terms of an efficient future crisis management framework, it was heavily debated what would follow after the EFSF and the EFSM would expire in 3 years time. What kind of governance should follow the rescue packages in terms of permanent institutions and decision making?

This paper addresses the political and economic medium-run and long-term consequences of establishing the EFSF and the EFSM. Moreover, it assesses what needs to be done using the window of opportunity of the next three years, from the commencement of the EFSF in 2010 to its mandate's end in mid-2013. Which institutions, if any, need to be formalized, and what shape will they take? This paper evaluates alternatives on establishing permanent instruments to support the euro. Clear from the very beginning was that any new mechanism should contain rules on decision-making procedure, funding, conditionality for loans, monitoring, as well as resources and powers to facilitate borrowing and lending activity in exceptional circumstances. It must also facilitate the orderly resolution of sovereign debt and private debt of major financial institutions.

II. Background: Governance of the Euro Area

Where do we stand? In light of the history of the European Monetary Union (EMU), what are the consequences of the recent rescue package in terms of long-term institutional solutions? There is still unfinished business concerning sound governance of the euro area. Faced with the "cold turkey" rescue plan launched on May 10, 2010, investors were briefly impressed. European policymakers showed they were capable of agreeing on dramatic measures (Annunziata 2010, Sinn 2010).

Rather soon, however, investors realized that the gigantic rescue package was directed toward support for the weaker members in the form of a huge stabilization fund and direct ECB sovereign bond purchases. At the same time, there was a clear lack of action on fostering fiscal discipline and improving cooperation in the event of crisis. There is overall agreement that the euro area in its current institutional shape has lacked the ability to enforce fiscal discipline. In this light, some investors and commentators have even expressed their doubt about the euro's survival. The underlying problem is that the Stability and Growth Pact (SGP) is neither sustainable over time nor enforceable. There remains no mechanism that overrides national sovereignty (Annunziata 2010, Sinn 2010).

Since the start of the EMU, the official political line has been to praise the SGP as the institutional mechanism suited to guarantee fiscal discipline and coordination. But any assessment of the first ten and a half years has to acknowledge that one member country, namely Greece, has in the meantime turned to the IMF to avoid bankruptcy, and that the entire euro area appeared and partly still appears vulnerable to a systemic debt crisis (Neumann 2010). Why and how did it all go wrong?

First, a currency union cannot work without sufficient fiscal convergence if there is not a high degree of economic integration (Krugman and Obstfeld 2009, 565). Second, the euro area has not been capable of creating credible incentives for fiscal discipline. On the contrary, the creation of EMU has lowered the incentives by eliminating the exchange rate risk at the country level. At the same time, a perceived "implicit bailout" insurance scheme induced lower credit risk premia and sovereign bond yield spreads. This kind of interest rate convergence based mainly on soft budget constraints is clearly the opposite of what the founding fathers of the euro area had in mind (Annunziata 2010, Sinn 2010). Moreover, it is the result of rating agencies that want to avoid publishing stand-alone ratings of countries that would rightly exclude the difficult to quantify and politically biased convergence effects of sovereign bailouts.

It thus did not come as a surprise that fiscal convergence did not happen and some countries have run unsustainable fiscal deficits and/or accumulated huge stocks of public debt. In parallel, it proved rational for markets to ignore this lack of convergence. It appeared a safe bet that, if necessary, a member country would be bailed out by its partners. The irony is that for ten and a half years the markets behaved exactly how the ECB said they should. In other words, they looked at the euro area *as a whole* rather *than at individual* countries (Neumann 2010). The convergence of interest rates that the SGP targeted did manifest itself de facto in the EMU period until the financial crisis set in, but for the wrong reasons (Annunziata 2010).

Once some countries' irresponsible fiscal policies upset markets, a "passive" fiscal integration, namely the support of weaker members via loans subject to conditionality, turned out to be the only way to keep the euro area together. The implicit bailout clause defined above was thus converted by a toggle switch into an explicit one in the form of the rescue packages. Admittedly, member countries are not formally taking responsibility for one euro area member country's liabilities. Thus, there is no breach of the treaty's letter. But the treaty's spirit is not upheld because the bottom line of all these measures is that no euro area member country, no matter how strongly it offends the rules of the game, will be left out in the cold (Annunziata 2010, Gros 2010b). The key choice facing the task force under EU President Hermann Van Rompuy is: should the Union direct its efforts at preventing failure (including open-ended fiscal support),[1] or should it also prepare for the failure of a member state in order to mitigate the consequences should it fail?

The first choice is bound to imply elaborate measures designed to deliver "more of the same," namely a strengthening of the SGP, for example, with more provisions for economic policy surveillance and cooperation. So far at least, it seems that most member states (and EU institutions like the Commission and the ECB) were publicly only considering this approach. But this approach did not provide any answer to the fundamental question of what to do if the currently

[1]There is a strong analogy to the argument developed in my previous briefing paper with respect to the ECB bond purchasing programme. With the SMP in place and having bought significant amounts of Greek debt before May 2010, the danger has risen that the ECB will get caught up in the maelstrom of its role of a lender of last resort. The more bonds the ECB will buy, the more difficult it will be to deny further sovereign financing in the future because doubts on the markets will prevail until an institutional solution of debt restructuring will be installed as a fiscal agent to be financed by the governments themselves and not through the creation of money (see Belke, 2010).

chosen three-year framework doesn’t work. As long as EU political leaders were not able to answer that, financial markets would have continued to be unsettled by doubts about the euro’s long-run stability (Gros 2010b). This might have been the reason why, for instance, other solutions such as an insolvency mechanism for countries, taking into account an insolvency risk larger than zero, were discussed and played through secretly behind the walls of German ministries before the ESM was decided upon.

We have to keep in mind the lessons learned so far. For one, the euro area cannot stabilize in political and economic terms without a framework for crisis resolution and without the capacity to cope with sovereign default by a euro-area member state. If one adheres to the view that member states cannot be allowed to fail, this logically implies that a *political union* or, at the minimum, a *fiscal union* must complement the euro. This is the decision that European political leaders and also the European Parliament inevitably came to in the last quarter of 2010: either a drastic step forward toward more political or fiscal integration, or a clear framework to match and to cope with the effects of a member country's failure to obey to the rules of EMU.

In the former case, the key conclusion that both choices involve relinquishing political sovereignty. If bailouts are the only mechanism allowed, the uncertainty of how many resources would be needed effectively implies ceding control over national output -- the same as under a fiscal or political union. This runs into the same problem that led to the failure of the SGP -- unwillingness to impose the sanctions written in the pact when the debt and deficit limits were breached is motivated by unwillingness to cede sovereignty over fiscal policies. Thus, the “half-way-house” of a monetary union to reap the benefits of eliminating exchange rate volatility and trade barriers to encourage greater cross-country competition has been (is being) revealed to be unworkable through the EU experience.

The leaders of France and Germany are now hoping to gradually move EU members in the direction of greater fiscal coordination and integration through a shared “golden rule” of achieving balanced budgets. Spain has introduced a debt brake right now and Portugal and even France are seriously thinking about it. Again, however, the short-term reaction of bond-traders suggests that they remain unconvinced about the adequacy of those measures.[2]

In the latter case, no more integration would have been necessary, but just the

[2]I am grateful to an anonymous referee for this argument.

courage of political leaders to publicly admit failure. No amount of money would have allowed European leaders to circumvent this issue (Gros 2010b). It is, thus, important to state that the exact amount of money contained in rescue packages is only of second order importance when assessing the impacts and the success of such a package. Of first order importance was and still is a public commitment by politicians to one of the alternatives.

III. Consequences of the ESFS and EFSM

It is critical to underline that there are important analogies between the consequences of the establishment of the EFSF and the EFSM, and the effects of the SMP. I argued in my June 2010 briefing paper for the European Parliament that around May 9/10 markets might not necessarily have behaved in an irrational manner. On the contrary, their fear of not getting their money back was realistic. Facts clearly spoke against the idea that both the huge interest rate spread increases and the drying out of markets are really “dysfunctional” phenomena: Greece’s and also Portugal’s domestic savings were so small that these countries were not capable any more of keeping their capital stock constant and financing their public deficits. Looking at the development of sovereign bond spreads after the implementation of the rescue package, this informed guess and minority view has been clearly corroborated.

Admittedly, the establishment of the ESFS and the EFSM buys limited time for more systematic action, in much the same way the SMP did. However, again in the same way as the SMP, it introduces an element of subsidy that tends to weaken the fiscal discipline of euro area member countries. The interest rate premium on bonds of fiscally weaker countries is intended to decline and the premium for stronger countries is intended to increase as soon as bad weather returns in the form of setbacks in Ireland or Greece. If installment of the ESFS and the EFSM is successful, fiscally solid countries would be punished and the less solid ones, in turn, would be rewarded for their lack of fiscal discipline and excess private and public consumption. The credit risk would thus be rolled over from the bonds of the weaker countries to those of the stronger ones if the window of opportunity would not be used for credible consolidation in the weaker countries and sovereign default is a probable issue.

It is no contradiction that, according to recent evidence, Germany has even gained in the short run in terms of its bond returns vis-à-vis, for instance, Ireland, as long as the rescue package does not have a too high probability to be activated. This is again a further piece of evidence in favor of the view that bond markets are not dysfunctional and because they differentiate between specific country risks. However, the current scenario is a fragile construction because if an emergency strikes, things might quickly change and markets will anticipate Germany's high financial burden within the rescue package. So everything hinges now on the credibility of budget consolidation in the weaker countries. This credibility is still rather low in cases of countries which have not aimed at the most promising consolidation mix in times of near bankruptcy, according to which two thirds consist of expenditure cuts and one third being tax increases (Alesina and Ardagna 2009).

Effects of the rescue packages have to be assessed against the facts that, currently, the previously booming PIGS are in deep economic crisis and Europe is currently struggling to arrive at a new equilibrium in accordance with the real constellation of country risks. The most important aspect of the temporary rescue packages then is that they impact on the speed of equilibrium reversion since they tend to slow down the speed and potentially also diminish the scope of short to medium-run sovereign bond yield differentiation in the euro area. This observation has to be attuned with a second, probably dominating one.

That is, the crisis will also have long-term implications for the euro area since budget constraints in the previously booming PIGS will be tightened for many years. This pattern is due to significant capital flows out of these countries which take place because the assessment of country risk by investors has fundamentally changed. German economist Hans-Werner Sinn accordingly argues that "investing funds in Greek state bonds, the Spanish construction industry or US mortgage backed securities is no longer seen as attractive, since the fear of default dwarfs all promised returns" (Sinn 2010, 18).

According to the data, investors have dissociated themselves from their view that country risks only consist of exchange rate risks. The common fears that the former "southern" weak currency countries eroded their national debt by an inflation-cum-devaluation policy have thus simply been substituted by the possibility of private and sovereign debt defaults (Sinn 2010, Burda and Wyplosz 2009, 343).

Markets now anticipate events which they had not previously thought possible. Thus, they claim compensation for the perceived risk by means of interest premiums. As mentioned above, for instance, a closer inspection of the pattern of the euro area country sovereign bond yield spreads (or, equivalently, of most other investment categories) vis-à-vis Germany supports this view. In the first few days after the rescue measures were implemented the spreads declined somewhat just in order to increase again afterward, potentially due to a lack of credibility of the rescue measures limited to three years and the lack of agreement of the French-German axis. In other words, the markets anticipate that the packages do not address some of the key, underlying issues.

In principle, this can represent a beneficial correction of markets that curbs the overheating of the capital importing PIGS as a result of soft private and public debt constraints. Quite independent of the political decision-making process, the market is now enforcing the necessary debt discipline and putting an end to the regime of soft budget constraints that pervaded the euro area (Sinn 2010). If this is true, the economic effects of the ESFS and the ESFM have to be evaluated with respect to their low effectiveness. At any rate, the interest rate data clearly support the view that the rescue measures currently do not have the potential to stop the selfcorrection process initiated by the markets. Already a month after the agreement on the ESFS and the ESFM, the bond yield spreads surpassed previous levels. What is more, they have from time to time been still on a much higher level than before the EU debt crisis (Sinn 2010).

Regarding political consequences, it was not quite clear in the second half of 2010 what the reactions of EU leaders would be to the fact that the markets which were frequently condemned after the financial crisis proved to be the only effective means to cope with soft sovereign budget constraints. This seemed to imply that the political decision-making process is probably not involved in the long-run problem solution to these soft constraints – at least as long as no exit of a member country from EMU was foreseen. This is something I would like to call a "*first political consequence*" from the status quo status of EU governance.

The rescue measures as of May 2010 were intended to reduce the risk of country defaults for a maximum duration of three years and to diminish interest spreads. With this mechanism, the rescue package has potentially reestablished the prior capital flows and thus unnecessarily extended the high growth period of the PIGS. This is because the package subsidizes capital invested in the PIGS by means of socializing the risk of default. This might be called the "first economic consequence" from the EU governance status quo prevailing at that time. As German economist Hans-Werner Sinn put it, "they ultimately entail a softening of budget constraints and promise little good for Europe" (Sinn 2010).

A second order economic problem would consist of a further initialization of capital flows that were already excessive before. Projects with an inferior marginal rate of return would continuously be financed which would, according to standard growth models, lower the growth of aggregate GDP in Europe. This could be labeled the "second economic consequence" of the status quo. In the worst case, the default risk would become even larger due to poorer growth prospects, with potential contagion of all euro area member countries (Sinn 2010). A default of the major European countries would then have unpredictable effects on the political stability of Europe. In a sense, this represents the "second political consequence" of the institutional status quo in the euro area. As stated above, increasing bond spreads in the euro area could well be interpreted as an early warning sign that markets did not trust the rescue packages.

Just to summarize: the good news contained in the above analysis is that market-led equilibrium reversion (i.e. convergence) without political intervention might generate more balanced growth in the euro area, smoothing out the external imbalances within the euro area. An increase in prices and wages will reduce, for instance, Germany's competitiveness and foreign account surplus (Gros 2010a). This macroeconomic result corresponds with the vigorous demands of French officials like finance minister Christine Lagarde. However, this pattern is produced in an endogenous fashion rather than exogenously by means of government-led wage negotiations, as a consequence of the redirection of capital/savings flows and the induced economic boom (Gros 2010a, Sinn 2010). However, this process may take time, something in between a complete business cycle and a decade because some restructuring of the labor force is involved. For instance, within the PIGS, labor has to move from the non-tradable to the tradable sector, which might lead to political resistance.

IV. New Institutions and/or Modes of Decision-Making?

The European Union and the EMU were and are in dire need of a model of economic policy management that, on the one hand, delivers more than the hitherto implemented fiscal coordination and the latest ad-hoc responses to the crisis and, on the other hand, a solution that cannot circumvent market forces but has to live with them. Many political and economic actors label this kind of management economic governance. What it actually means in EU institution circles is a more effective management of national fiscal policies, and the monitoring and correction of negative macroeconomic developments like the lack of convergence in growth and a permanent crisis mechanism (Heinen 2010).

The Council of European Heads of State or Government agreed on "first orientations" regarding economic governance on 17 June 2010. With respect to fiscal policy, the effectiveness of the medium-term objectives of the preventive arm of the SGP has to be enhanced, for instance by employing sanctions, national budget rules, and medium-term budget planning by EU member states. Government debt, both its level and its trend, must play a bigger role in the SGP. In addition, stability programs for euro area countries and convergence programs for non-euro area countries were envisaged to be presented for screening to certain European institutions before their adoption from 2011 onwards in the framework of the "European semester." The aim of the "orientations" is to reach better coordination and to arrive at timely action in case of negative developments. Quite important in view of the Greek case, independent statistical authorities have to assure the quality of statistical data. The agreements on stricter macroeconomic surveillance stipulate the application of a scoreboard for an assessment of the trends in competitiveness and macroeconomic imbalances, and identifying negative developments in a timely fashion (Heinen 2010).

Ideas for joint economic governance were under discussion in the task force headed by Mr. van Rompuy. Publication of the first proposals for the future management of economic policy in the European Union and EMU was due in October 2010. Important position papers have been published by the EU Commission (May 12 and June 30, 2010), the European Central Bank (June 10) and the finance ministers of Germany and France (July 21, 2010) with proposals for European economic governance (Bundesministerium der Finanzen 2010, European Commission 2010a, ECB 2010a).

The position papers contain both proposals for effective coordination of fiscal policy and macroeconomic surveillance, as well as proposals for future crisis mechanisms coined for the European Union and the euro area. The proposals of new modes of governance in terms of institutions and decision-making share similarities, but there are also remarkable differences between them. Their most striking similarity is that they direct their efforts solely at preventing failure instead of preparing for the failure of a member state in order to mitigate the consequences. This is hazardous because of the nearly unchanged macroeconomic problems of Greece, Portugal, Spain, and Ireland. What is more, as long as no member country is granted to go insolvent, the euro area can continue to exist only if all its members act in a cooperative manner.

A. Institutional alternatives to support the stability of the euro?

The preventive arm of the SGP is intended to enable more extensive intervention in national budgetary policy in the future, with a stronger focus on the sustainability of government debt and the condition that national budgets must be run compatibly with the SGP. Sanctions proposed by the Commission, and the German and French finance ministries, consist of the lodging of interest-bearing deposits by member states not complying with the medium-term objectives of the preventive arm. The ECB did not issue concrete proposals for sanctions, but did so for surveillance mechanisms. It proposed the introduction of an independent fiscal agency to conduct permanent surveillance (Heinen 2010).

With respect to the corrective arm, there was discussion about speeding up the excessive deficit procedure (EDP), and imposing quasi-automatic sanctions together with a reversal of voting arrangements. The latter implies that Commission proposals would then have to be rejected by a qualified majority of the Council. It is important to note that at present they must be approved. This last proposal that referred to a new mode of governance in terms of decision-making stems from the ECB and reaches further than the provision originally agreed upon by the European Council. This meant there was no prospect of its implementation for the time being because it would potentially presuppose an amendment of the treaty (Heinen 2010). Moreover, its democratic legitimacy was at stake.

The final recommendation made by the Commission and the Franco-German duo was the introduction of a “European semester.” The semester consists of a phase in the first six months of the year during which the national budgetary policies and the economic policies of member states are coordinated for the following year.

A common feature of all macroeconomic coordination proposals is that they proposed an installment of an early warning system accompanied by intervention measures administrated by the Commission. However, the individual proposals came up with different indicators and different types and prospective severity of the sanctions. As expected, the strictest stance has been taken by the ECB. It proposes sanctions that are modeled on the EDP. Closely connected with this, Heinen (2010) points to an interesting Franco-German proposal at that time potentially entering into a political arrangement when voting is being conducted to achieve a de facto denial of voting rights. This proposal would not require a treaty amendment and, thus, serves the principle of democratic legitimacy.

Finally, all proposals called for a crisis mechanism for countries in serious difficulties. This mechanism could only be set in action under strict conditionality to minimize the risk of moral hazard. The ECB also published proposals regarding the establishment of a euro area crisis management institution, which would have many of the features of the EFSF (Constâncio 2010). Also, and especially from the ECB's perspective, it is crucial to minimize the risk of moral hazard, which is always implicit in any ex ante rescue mechanism and might impact on mediumrun expectations of inflation. Strong conditionality, reproducing the EU/IMF financial support to Greece, and graded sanctions in case of non-compliance with conditionality, escalating to a de facto loss of fiscal autonomy as the extreme form of sanction, would be institutional safeguards (Constâncio 2010). While the Commission's proposals emphasized solutions and compliance with certain conditions, the ECB's focus was on sanctions. This is tougher but could hold even greater potential for conflict. Currently, however, this does not present an acute problem as the existing crisis mechanism (EFSF) bought time and will not need to be replaced until 2013 (Heinen 2010)

Some of the ideas set out in the Commission's June 2010 Communication on enhancing economic policy coordination for growth and jobs were close to the ECB's proposals (EU Commission 2010b). However, for instance, Constâncio (2010) argues that the ECB's proposals were somewhat more ambitious because they "feel that the situation requires a quantum leap forward in strengthening the foundations of EMU and moving towards a deeper economic union" (see also Bini Smaghi 2010).

B. The position paper proposals: an assessment

Heinen (2010) presents an excellent and compact synopsis of the position papers and also assesses the proposals contained in terms of three realizations of grades. The main result is that the European Commission, the ECB, and the German and French finance ministers have produced clear papers that are not grounds for optimism. Their analysis of the key underlying problems is lucid and focused. The recommendations, however, according to Annunziata (2010) and others, indicate that we are about to repeat the same mistakes of the past again.

The suggestion of the Commission to introduce a more comprehensive framework of ex-ante policy coordination, with a European semester, aims at keeping individual countries to their fiscal targets and avoiding persistent intra-euro area imbalances (Belke, Schnabl and Zemanek, 2010). But it is left open what could actually force countries to change their budget plans according to the Commission's recommendations. The Commission also proposes that countries exceeding the SGP deficit ceilings should be forced to set aside funds in interest bearing deposits. But again, as Annunziata asks, "what makes us think that these interest bearing deposits would be enforced, when the fines already envisaged in the SGP have never been levied?" Commission proposals would then have to be rejected by a qualified majority of the Council. But in scenarios like the current one in which the qualified majority of member countries have preferences that go beyond the notion of EU economic governance as a mere hardening of the SGP, credible enforcement of budget discipline might become a difficult task even in good times.

The problem inherent in both the old and the proposed SGP is that they have no mechanism to override national sovereignty. Taxing and spending decisions rightly rest with the elected representatives of each individual country, and since there seems to be no appetite for full political union at least in the former hard currency countries, this is not going to change.

V. Three Possible Alternatives

A. Expulsion of a country from the euro area

There are then only three possible ways of setting the right incentives for fiscal discipline. The first would be for the euro area to use the only credible threat available to any club: to revoke membership. The treaties could in principle be amended to specify conditions under which a country would be automatically expelled from the euro area (Neumann 2010). However, this might be a too "Germano-centric" solution for the majority of countries.

What is more, some argue that there are at least two serious flaws in this idea (see Annunziata 2010). The first caveat is that the punishment might be "too harsh to be credible": expelling a country from the euro area would have serious impacts on the sinner and dramatic spillover effects on other members. The second is that it would provide an ideal setting for speculation, the nemesis of European politicians. A country approaching the conditions for expulsion would quickly find itself under immense market pressure, as some investors would bet on its inability to redress the situation and others would need to hedge themselves against the potential consequences of it being kicked out (Annunziata 2010).

One could argue that this misses the point because the fundamentals of Spain and Italy, especially in their self-financing capacities, appear much stronger than those of, for instance, Greece and Portugal. And this in itself speaks against the case that contagion might pull also Spain and Italy down. Moreover, neither Spain nor Italy would gain much from a default since most of their public debt is held by their own citizens. A default would thus not lower the foreign debt of the country (Gros 2010c). The litmus test for the euro area is thus not whether it is able to save a country like Greece, but instead whether it can protect members from speculative attacks that do not suffer from any insolvency problem (Gros 2010c).

B. Implementation of a european monetary fund

A second solution would have been the immediate installment of any sovereign default mechanism such as a European Monetary Fund (EMF), i.e. the conversion of the starting capital provided by the European Stabilization Mechanism which currently is not more than a Special Purpose Vehicle into a EMF, which will be discussed more below.

C. "Hard-coded" national fiscal limits

A third potential solution would be to "hard-code" fiscal limits into each country's legislation by means of automatic, binding, and unchangeable rules. Annunziata, for instance, advises euro area policymakers adopt the Polish procedure that lets the constitution set a public debt ceiling. Every euro area member country should be obliged to implement this clause in its own constitution as a condition-sine-qua-non for uninterrupted membership. Annunziata also proposes that any deletion or amendment of this clause later on should lead to an automatic exit from the euro area. A mechanism to override national sovereignty would no longer be necessary, since each national legal framework would automatically preserve the common fiscal rules. By obeying the bottom-up, i.e. subsidiarity, decision pattern his would clearly serve the principle of democratic legitimacy. "It is hard to force a country to follow the policy dictates of its neighbor," Annunziata argues, "but it should be much less controversial to argue that all members of the club should pledge allegiance to the commonly agreed rules in a fully binding way."

Such a solution turns out to be politically demanding. But authors like Annunziata correctly state that the challenges are severe enough to justify politically courageous decisions. The euro area with its current institutional framework has sown the seeds of a larger moral hazard problem that will not be made obsolete by the conditionality connected with EU loans. One option for countries to cope with this problem is to internalize the euro area's common objectives. As Annunziata puts it: "Requiring countries to amend their constitution sets the bar high - but it is the kind of step that would demonstrate near-irrevocable commitment to fiscal discipline, and the dividends in terms of credibility would be enormous."

In this sense, it would be a waste of time to continue with a SGP that is unenforceable (because it can never override national sovereignty) and time inconsistent (because when the time to tighten policy comes, countries have no incentive to do so). The euro area member countries should commit to serious fiscal responsibility, the price to pay for remaining in or acceding to the euro area. This commitment could be made binding and effective by embedding the common fiscal rules within national legislation (Annunziata 2010). But the problem with this is that it seeks to bind the hand of future national legislatures, something that may be just as difficult to accomplish politically because, again, it dilutes discretionary control of fiscal policies. If future national interests dictate that the nation would be better off outside the common currency system (if the costs and burdens of staying outweigh the benefits), future legislatures would repeal such clauses. Such a solution must be coupled with a mechanism to ensure that the benefits from exiting almost always outweigh the costs which appears to be prohibitively difficult.[3] Moreover, this institutional solution would of course not directly tackle the remaining larger problem depressing the euro area and is hampering convergence, i.e. the lack of progress in structural reforms. However, imposing binding limits on fiscal deficits would indirectly reinforce the governments' reform incentives since higher growth rates would render fiscal adjustment less painful. How would this work for countries already at the debt limit? But any "reforms" to stimulate growth while avoiding spending increases and tax cuts are close to impossible. The only avenues remaining are regulatory liberalizations that would not affect the budget directly and negatively. Whether such reforms are available and politically feasible on a sufficiently large scale needs to be evaluated carefully before.[4]

[3]I am grateful to an anonymous referee for this argument.
[4]I owe this argument to an anonymous referee.

D. A postscript to the proposals

With regard to economic policy, it was clear that the issue of different proposals for euro area and non-euro area countries would come onto the agenda again sooner or later. Such a differentiation was emphasized in the position papers published by the Commission and by the Franco-German finance ministers. They stressed sanctions and conditionality to a lesser extent for non-euro area countries. Whereas leaving room for convergence might be a plausible first glance argument in favor of this unequal treatment, the question looming on the horizon is whether and by how much an economic "core Europe" could decouple itself from the non-euro area countries and, by this, indirectly lower their probability to enter the euro area in the future.

As for the European semester, the treatment and integration of national parliaments disposing of budgetary prerogatives is a critical issue. The national parliaments tend to insist on exercising their rights that makes a European peer review of draft budgets prior to the national budget process unlikely in the near future. This creates a constitutional problem that could not be solved by integrating the European Parliament. These problems notwithstanding, the European semester would even be useful for coordination by means of the exchange of information and creating transparency of information flows (Heinen 2010).

Finally, it would have been interesting to see whether and by how much market expectations would be impacted by quasi-automatic sanctions and a reversal of the burden of proof in the EDP. It cannot be excluded that the triggering of the EDP could have caused significant reactions by the markets. On the other hand, a change in processes of this kind, like the European semester, would be a clear sign of a paradigm shift toward more serious budget coordination that could be rewarded by the markets (Heinen 2010).

All three documents, the position papers by the EU Commission, the ECB, and the French-German one, referred to the objectives of the Europe 2020 growth agenda. On the one hand, this might give reason for some commentators to hope that this growth agenda may be more successful than its predecessor (Heinen 2010). On the other hand, it may only serve to contribute to "Europe's competitiveness obsession," a notion coined by Gros (2010a). He asks whether higher productivity is leading to higher competitiveness and, thus, really the way out from intra-euro area divergences. Across the European Union, even the opposite is true in many cases. For instance, Ireland which experienced the highest growth in labor productivity at the same time, lost competitiveness to the largest extent. This is because improvements in productivity are easily overwhelmed by changes in wages.

The last part of the puzzle is to solve the central question of what determines wages. There is ample evidence that, in the last ten years, the largest wage increases took place in countries like Spain or Greece that experienced the strongest domestic demand growth. Thus demand drives wages and not the other way round, since the PIGS suffered from the bulk of the loss of competitiveness *after* unemployment in these countries had fallen sharply. The statistical loss of competitiveness of the PIGS thus should not be traced back to inadequate reforms or aggressive trade unions, but instead to booms in domestic demand. The latter has been driven above all by cheap credit for consumption purposes in the case of Greece and for construction work in the cases of Spain and Ireland. This, in turn, translated into higher labor demand and, as a consequence, also to higher wages (Gros 2010a).

If excessive domestic demand in the PIGS was the problem, the solution to intra-euro area asymmetries should now be approaching. This is the other side of the coin of the purely marketdriven equilibriating process. In this section we have shown that international investors already curtailed credit to the PIGS. The bold austerity programs launched in these countries should contribute further to lower growth rates of or, in some cases, even a sharp decrease in domestic demand there. If labor markets are flexible, this should result in lower wages. Indeed, that is the key: labor-market flexibility on the way down as much as on the way up (Gros 2010a).

The proposition that governments "must do something about competitiveness" risks leading to an excessively activist approach to economic policy coordination, with governments and EU institutions constantly trying to influence wage-setting in the private sector" (Gros 2010a). This activist approach has the potential to work at least partially in the current crisis. However, if domestic demand starts to diverge again, the same activist approach will not be able to prevent future divergences in competitiveness. Enacting structural reforms is useful in many cases. However, fostering productivity takes years and there is no guarantee that it really feeds into higher competitiveness. Instead, the southern European member countries must accept that domestic demand has to fall to a level that makes countries independent of protracted inflows of foreign capital (Gros 2010a). Once this threshold is taken, it should be enough to give labor markets sufficient leeway to approach and to settle at its new equilibrium.

E. Preliminary conclusions

At the time of writing this paper, at the end of September 2010, it was much too early to check whether the work of the task force would actually endow the European Union and EMU with robust convergence enhancing measures in times of larger uncertainty than usual. The outlook appeared mixed, if the proposals made by the van Rompuy task force were based on the published orientations and position papers, and not on the three alternatives presented in this section. Their main problem is that they are based on the fiction that the euro area is strictly not allowed to lose even a single member. The proposal of a European Monetary Fund (EMF) is to get rid of the latter fiction but try to be as market and incentive compatible as possible.

V. The European Monetary Fund: More Pros than Cons

Gros and Mayer (2010a) argue quite convincingly that setting up an EMF to deal with euro area member countries in financial difficulties is superior to the option of either calling in the IMF or muddling through on the basis of ad hoc decisions. With respect to its financing mechanism, conditionality, enforcement, and the orderly default mechanism involving creditors as well, it does entail more limitations to moral hazard than other proposals. Gros and Mayer have suggested that this fund operate as an insurance scheme based not on euro area country premiums, because the very existence of the EMF itself depresses CDS spreads and yield differentials within the euro area, but on the compliance of euro area countries with the Maastricht deficit and debt levels (Gros and Mayer 2010a, 3). The less disciplined a country is in budgetary matters, the more it would pay in. This might work much like an efficient preventive arm of the SGP.

Moreover, the ECB's 10 June 2010 position paper came up with similar positions without referring explicitly to the EMF. Most strikingly, the ECB proposals might also necessitate treaty changes, in the same way as the EMF does. This property, however, was used, for instance, by Angela Merkel as a K.O. criterion against the EMF (New York Times, 2010). Actually, it is a subject of debate whether you would need a treaty change to create an EMF or not. Up to now one can even think of a legal opinion saying that you do not need to touch the treaties to create such a fund, and that a unanimous decision of the 27 heads of state and government would do. But also in this case you may ask what is wrong with installing an EMF when the ECB comes up with a rather similar proposal and the latter does not even emphasize any need of a treaty change.

Thus it is interesting to see what the position of the German government will finally be with respect to the ECB proposals. Without a clear framework, decisions about how to organize financial support typically have to be taken hurriedly, under extreme time pressure, and often during a weekend when the turmoil in financial markets has become unbearable.

The proposal by Gros and Mayer is not meant to constitute a “quick fix” for a specific case. Greece is the problem today, but it will not go away quickly. The experience of Argentina shows that default arises only after a period of several years in which economic and political difficulties interact and reinforce each other. Failure is not inevitable, as the relatively successful experience so far with tough adjustment programs in Ireland and Latvia show. But what is unavoidable is a period of uncertainty. With an EMF, the Union would be much better prepared to face such difficult times.

But some countries, political leaders, and even the ECB have resisted the idea, raising concerns about having to bailout other EU countries due to their own reckless financial behavior. Others wonder whether an EMF is repetitive, overlapping with the IMF.

There are several arguments in favor of the view that installing an EMF is necessary beyond the role of the IMF. In the first place, a EMF creates a global and a regional system (Johnson 2010). Other IMF-like regional funds that have been created outside the euro might serve as the blueprint for it (EU Business, 2010). This would also deliver more symmetry in the distribution of funds worldwide. Another advantage is that installing a EMF avoids “foreign” IMF intervention, which might be strategically important in times of the euro area struggling for more impact in international organizations like the IMF or the G-20 (EU Business 2010). Any IMF bailout would undermine the European Union’s legitimacy.

As expressed by the German finance minister, the European Union needs a EMF with power equal to that of the IMF for the internal stability of the euro area (BBC 2010). Moreover, the EMF is specially designed for the euro bloc, whereas the IMF was not designed for developed euro countries (New Europe 2010). Seen on the whole, thus, installing an IMF is neither just reinventing the wheel with an already existing suitable tool, the IMF, nor is a potential EMF which can dispose of the SPV billions of funds not big enough to save entire EU countries. It does also not seem to be the case that the IMF has true neutral bargaining power. Even without relying on a sometimes doubtful U.S.-bashing saying that the IMF is U.S.-dominated and also follows strategic interests in supporting countries more leniently which grant the location of

U.S. military bases like, for instance, Greece, two facts stand out: 1) During the negotiations with Greece on the conditionality of the rescue package, the IMF proved less hardnosed than its two European counterparts of the "troika." 2) One could be forgiven for thinking there is only limited U.S. interest in the stability success of the euro area because this would eventually mean the loss of the reserve currency in the long run (Belke and Schnabl 2009).

In terms of efficacy, the EMF would be able to deal with crises effectively. The EMF would improve EU fiscal federalism/coherence without incurring much of a moral hazard (Thoma 2010) and, even more important would allow orderly sovereign default. It could impose tougher sanctions than the IMF (New York Times, 2010). The EMF could also enhance the transparency of public finances because its intervention mechanism in the case of failure would penalize all derivatives and other transactions that had not been previously registered with a special registry of public debt, which the EMF would maintain (Gros and Mayer 2010a, 4). Just to state that the EMF is not a short-term solution to immediate crisis does not make sense since the emergency measures already taken have opened a window of opportunity to install a long-run mechanism. The installment of an EMF is feasible because it could be financed effectively and would work much like the IMF, which stopped enormous bankruptcies in order to ensure the world economy's safety.

A simple funding mechanism would also limit the moral hazard that potentially results from the creation of the fund (Economist 2010b). Only those countries in breach of set limits on governments' debt stocks and annual deficits would have to contribute, giving them an incentive to keep their finances in order. This is exactly the reason it cannot be claimed that the EMF would encourage fiscal irresponsibility.

Concerning non-normal times, however, the EMF suffers from a drawback that is inherent in some other solutions such as the IMF solution, and the EFSF and its Special Purpose Vehicle. This drawback has, for example, been addressed by Perotti (2010) who argues referring to the Gros and Mayer proposal that: "(B)y the authors' calculations this facility would today give Greece access to something like. 65% of its GDP ... plus any additional discretionary fund from the pool of all accumulated savings. However, 65% of GDP would make no difference to Greece today; and ...

the intervention needed would eat up the whole fund just for a small country like Greece. The key problem country, Spain, with a public debt just above the Maastricht level this year, would have made virtually no contribution to the EMF. In the end, effective intervention, especially when the risk of contagion is high, is likely to depend on the discretion of Germany and other non-problem countries, just as it does now." Moreover, the availability of financial means should be no problem since the newly created Special Purpose Vehicle could be directly converted into an EMF.

As for public opinion, the EMF follows two distinct principles. First, solidarity around EMF would matter more than moral hazard**.** Member countries of the European Union have signed up to the principle of solidarity. Hence, they can expect to receive support when faced with extraordinary financing difficulties. And second, during financial crises when a member state is on the brink of collapsing, public opinion should matter less than coherent plans to solve the crisis. The very fact that the EMF is funded proportional to GDP might be unpopular among big states. However, alternative institutional solutions such as the hardening of the SGP still rely on budget deficits and debt levels per GDP. In any framework of orderly default, creditors should be involved according to their involvement and this is often proportional to their GDP.

This is not to say that the EMF idea has no drawbacks. One potential problem might be that if the EMF is more strict in terms of its conditions, European countries will go to the IMF. Moreover, much like other sovereign funds solutions the EMF might siphon off capital and increase national borrowing costs (Gokhale 2010). The recent events around a potential Greek default have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programs lack credibility and the balance sheet of the ECB is put at risk by the Securities Markets Program (Belke 2010). Only sovereign funds reveal the true opportunity costs to the initiators. However, if one chooses the way through the ECB and the printing press via the SMP, the opportunity costs of adjustment program wrongly appear to be close to zero. So, what is the problem in making opportunity costs explicit by increasing borrowing costs? The alternative would anyway, in view of our results, not be a separate hardening of the SGP but, instead, the introduction of something like constitutional national debt brakes or even a return to the paradigm of "let the market mechanism play."

Usually, higher borrowing costs and disincentives to adhere to fiscal limits under an explicit and formalized bail-out mechanism would become larger than necessary. But this is not the case for the EMF according to the concept by Gros and Mayer (2010). It does not at all lead to disincentives to adhere to fiscal limits because (1) they suggest that this fund operate as an insurance scheme based on euro area country premiums. The less disciplined a country is in budgetary matters, the more it would pay in and, thus, a simple funding mechanism would also limit the moral hazard that potentially results from the creation of the fund. (2) If adjustment is unsuccessful, EMF becomes the sole creditor of the insolvent country through (mandatory) debt exchange. Thus, the EMF imposes further conditionality (limits on new borrowing) of the insolvent country so as to assure that the country can repay the EMF. Any breach of the conditions and/or default on EMF means a breach of EU Treaty obligations. For the respective country, his would finally imply leaving the euro area and ultimately dispensing with (the benefits of) the EU (Belke 2010a).

The simplest idea is to clearly establish the links between benefits of adherence to fiscal rules -- greater structural incentives to become competitive and reap the economic benefits of monetary union -- to the costs of doing so. If monetary union is worthwhile, it must be on such a net-of-cost basis. If countries are not willing to pay the costs of EMU membership by adhering to fiscal limits without external enforcement mechanisms or bailouts, they should be allowed to exit.

Alternatively, (as it appears) if more of the benefits of membership by smaller countries are accruing to the larger ones (e.g. by expanding their export markets), then it makes sense to impose larger costs on the larger member states. But this is better achieved by the conditional assistance we are witnessing today -- and which appears to be going forward, albeit through a painful bureaucratic negotiation process. Without structures that clarify these cost-benefit linkages, there appears no hope to align the incentives for adherence correctly. But there appears relatively much hope of achieving this clarity via establishing an EMF (Belke.

The "let the markets play" scenario is a solution that is strikingly underrepresented in the wide array of public proposals of instruments to stabilize the euro up now (Sinn 2010, section 3). Although all countries have announced broad-based bank rescue packages, investors have differentiated between countries mainly on the basis of other, more country-specific factors (e.g. the fiscal outlook). This pattern is usually revealed in a euro area context by a comparison of ten-year government bond yield spreads of euro area countries over Germany and the expected budget balance relative to Germany in a couple of studies mentioned regularly in ECB outlets. This has also been valid more recently from February

2010 on, when markets have increasingly differentiated among the weak members.

A policy implication of these findings is that market valuation of sovereign risk remains a valid mechanism to discipline fiscal policy especially but not only in times of financial crisis. Therefore, some even argue that there is little justification for the claim that governments faced with high risk premiums during the crisis deserve the solidarity of other governments in the euro area (Schuknecht, von Hagen, and Wolswijk 2010, and the papers cited in my June 2010 briefing paper for the European Parliament (Belke 2010, section 1). As stated above, the EMF does not go as far as this but maintains a conditional solidarity, i.e. countries in financed difficulties are entitled for financial support according to their previous payments and their agreement to tailor-made adjustment programs supervised by the Commission and the Euro Group.

Another counterargument is that the EMF cannot be set up without a new treaty. The creation of the fund may indeed face legal impediments (EU Business 2010). German Chancellor Merkel says EU treaties, which currently forbid euro area countries from coming to the financial rescue of another, must be changed. That could prove laborious in the extreme, going by the years of referendums and special exemptions required to ratify the Lisbon treaty. Countries like France have little appetite for new treaty negotiations. But if this knock out criterion is applicable to the EMF, this should also be the case for the ECB proposal as of June 10.

Finally, some argue that investing EMF assets abroad could cause consternation (Gokhale 2010). To ensure a credible commitment to crisis avoidance, the fund should be invested in non-European financial securities. But that would move investment away from Europe -something which member nations are unlikely to support. Further research should check the validity of these arguments and, in addition, whether they are relevant for the alternatives to the EMF, too. If the cons are weighted more heavily than the pros, and strictly enforcing budgets appears better than creating EMF, the solution must be to go for hard coded national fiscal limits.

VI. Not too Much Leeway to Act Independently– The ECB and Its Political Constraints

The first point I would like to make is the following. Since ECB representatives often argue that it had to engage itself in quasi-fiscal activities because politicians have not done their homework in terms of fiscal stability, it is important to look at the political economy of recent government (non-) action in the euro area. The recent proposals aimed at strengthening the euro area by the political leaders of Germany and France have received extensive criticism, even from key figures within EU institutions, for "offering too little, too late." Why are the major players of the EU dragging their feet in coming up with a comprehensive solution to the eurozone debt crisis – a problem which poses a heavy and immediate legacy for the era of Mr. Draghi, the successor of Mr. Trichet as well?

The answer is heavily related to how the current scenario which I will describe more deeply in the following tends to drive the markets and, hence, probably also the governments of the larger donor/guarantor countries. In early August 2011, a domino effect, leading to a significant plunge in bank assets, started to kick in because financial markets quite understandably do not wait for one country after another to be downgraded. Markets tend to anticipate the endgame, or at least one potential scenario of it, which probably consists of the unravelling of the entire EFSF/ESM structure (Gros and Mayer, 2011). And you can be sure that politicians are aware of it!

Markets were caught between three quite inconsistent constraints which cannot be alleviated by European politicians due to the given bargaining structure of the "game". First, a sizeable increase in the borrowing capacity of the EFSF is technically and politically not possible. Second, in the short- to medium run there will be no Eurobonds because it is against the interests of the largest and (still) most solvent guarantor country. And third the ECB is reluctant to engage in large-scale purchases of financially troubled governments' bonds and to accept huge haircuts for over-indebted, i.e., insolvent countries such as Greece (as opposed to illiquid countries). The German government, for instance, is strongly inclined to support the ECB in this respect, because the German population was promised a financially and politically independent ECB and a strict national responsibility of member states for their public finances in exchange for its dispense with the DM (Belke, 2011a).

Moreover, the sophisticated structure of the "endgame" of the euro area is quite difficult to handle. Among others, there is an obvious incentive for weaker member states to become insolvent as long as there are enough guarantors available. Moreover, as the Deauville agreement among Merkel and Sarkozy as of October 2010 showed, it is the high time of package deals right now: in that case Germany gave in with respect to its target to harden the pre-emptive arm of the SGP and France. Caught in a minority coalition of countries with more sound finances (joint with Finland, Austria and the Netherlands), Germany is especially keen on this kind of deals because it is fearing to be finally forced into agreements such as a "true" European Economic Government by the majority of euro area countries without having dominated the design of this new type of European economic governance (Belke, 2011a).

Finally, politicians of course strive to be re-elected by their home base. In Germany, for instance, federal elections will take place in 2013, i.e. the year in which the ESM will be put in place. Remember that Merkel lost important local elections in Northrhine-Westphalia immediately after she had agreed to the first Greek rescue package (Belke, 2011a).

Seen on the whole, thus, most of which looks like the often blamed hesitant and half-hearted politicians has a clear rationale. Economists would say: euro area countries maximize their power index, i.e. their probability of being members in winning coalitions (Belke and Styczynska, 2006, and Belke and von Schnurbein, 2011). Of course, this polit-economic constellation has posed a significant challenge for another important player, the ECB. Hence, it can be seen as a great achievement from the perspective of the ECB that Mr. Trichet came out of the EU summit on July 21st with a net loss of zero, i.e. being compensated for each potential percentage point of a haircut by equivalent guarantees delivered by the European taxpayer (Belke, 2011a).

My second point starts from the observation that boosting the European Financial Stability Facility is regarded by many leading economists and market analysts as a necessary step to calm the markets. So why should this be not realistic also from Mr. Draghi's point of view?

First of all, one should keep in mind that the EFSF was originally designed for a crisis in the periphery, i.e. large euro area countries provide emergency financial support solely to small countries such as Greece, Ireland, and Portugal. In particular, the EFSF simply does not and will not have enough funds to undertake the massive bond purchases required to stabilise markets (Belke, 2011a).

Moreover, the rules of the EFSF's renders it vulnerable to a domino effect (Gros and Giovannini, 2011): a country that is plagued by financial difficulties and itself requests support from the EFSF is allowed to step out. According to Art. 2(7) of the EFSF Framework Agreement, it may thus no longer provide guarantees for any further debt issuance by the EFSF. Moreover, a country facing high borrowing costs (as in the case of Italy and Spain if rates stay at crisis level) will step out as guarantor and only the core Eurozone members would remain to back the EFSF.

At this point, the debt burden on the core countries would become unbearable – due to the so-called cascade structure of the EFSF (see Belke, 2011a, and http://www.efsf.europa.eu/attachments/faq_en.pdf).

Hence, politicians and also ECB officials like Mr. Draghi are well-advised to acknowledge that there are significant dangers of applying the periphery solution to the core. This immediately makes understandable that – under current institutional circumstances - an ever larger EFSF cannot represent the solution. On the contrary, any envisaged increase to cover sums starting from 2.5 trn EUR (Buiter, 2011) to an incredible 4 trn EUR (Gros and Giovannini, 2011) could accelerate the domino effect because it either leads to step-outs of an increasing number of guarantors or leads to ever increasing refinancing costs of the EFSF if those countries stay in with an eye of the reputation loss they would experience if they would leave (Belke, 2011a).

That the French government has reduced its emphasis on the increase of the EFSF does also make much sense even from the French point of view itself. Sarkozy had to recognize that financial markets have understood the domino risk and have actually started to push up French borrowing costs. Just rumours of a boost to the EFSF have made France the EMU core country most in danger of losing its AAA rating. But if France really gets rid of its AAA status and is then forced to step out of the EFSF, there would only be Germany (and some of its smaller neighbours like Austria, the Netherlands and Finland which can be called its strategic "allies" in the current polit-economic game) remaining to carry the whole burden. This would not only be politically unacceptable, thus evoking growing nationalist tendencies, but also economically impossible – in terms of GDP Italy is eight times Greece and the Italian government debt alone is equivalent to the entire GDP of Germany (Belke, 2011a).

Finally, I have frequently argued elsewhere that a boost to the EFSF is equivalent to introduce a variant of "euro bonds" because the member countries jointly guarantee for each other (note that the term „euro bonds" is often used in the public debate in a way not specific enough). This is in strong contrast to the rescue programmes for the periphery which are characterized by a unilateral lower scale flow of guarantees and funds. However, any "euro bond" approach would make a change in the EU treaties necessary. Finally, it would probably not be compatible with the German constitution which is at least relevant for the German government and, thus, have an impact on Germany's behavior as a player in the current euro game (Belke, 2011a).

My third point starts from the observation that Greece has unmanageable levels of debt, which everyone seems to recognize except the EU leadership. Indeed, no plan offered so far appears to adequately address the Greek debt issue. So, an important challenge for Mr. Draghi is to answer on behalf of the ECB under what conditions can Greece avoid default and remain in the eurozone.

We should really be concerned that under the current projections and after the Summit of July 21st Greek debt looks set to increase in the short-term and will remain above 100% of GDP for years to come. Hence, I see the necessity of another adjustment being made in the future (Belke, 2011a).

Although parts of the agreements of the recent Summit point into the right direction, the extent of the concrete measures decided is disappointing. It does not have the potential to put an end to the debt crisis. Instead, the risk of contagion of other countries will increase. This is because the much too low haircut immediately sends the message to the market participants that an even more significant restructuring if not a more gigantic transfer of euro area countries to Greece will be necessary and take place in the future. Presumably, we will see an even more substantial debt restructuring in after 2013 when the EFSF will be substituted by the ESM and the German elections will have taken place. This view is supported in technical terms by the fact that the existence of the ESM will make restructuring of privately hold government bonds much easier (Belke, 2011a).

So also the ECB under the lead by Mr. Draghi is urged to take part in the process of defining conditions for a sustainable solution in the context of the whole euro area. This process could look as follows but is still a task quite open for future action. The latter, however, will be of enormous concern for the future role of the ECB.

Let us start from the usual observation that (not only) the Greek banks are the weakest link. They usually create negative feedback loops and accelerate the transmission of the domino effect described above. This is because many banks keep large amounts of government debt in their books and their credit rating usually shrinks in parallel with that of their own sovereign (Belke, 2011a). This has exactly been the reason for Mr. Trichet to be so keen on decoupling the euro area banks from their sovereign (see section 2 of this paper)

It is now apparent that capital markets are anticipating the potential for a doomsday scenario, with the economy falling abruptly into recession as the interbank market breaks down and public debt problems are expected to grow. Unfortunately, as Gros and Mayer (2011) argue these expectations will materialize unless the breakdown of the interbank market is addressed immediately. Thus, just to circumvent the worst thinkable scenarios, one option would be to follow Gros and Mayer (2011) in that the euro area is – whether one is ready to accept it or not - in need of a large-scale infusion of liquidity. Given that the existing cascade structure of the EFSF is part of the problem, the solution cannot be a massive increase in its size (see my remarks above). Rather, in a case of emergency, according to Gros and Mayer (2011), the EFSF should be granted access to re-financing by the ECB as a lender of last resort. The EFSF would thus be finally transformed into a European Monetary Fund (EMF).

With an eye on the structure of the polit-economic euro game, my guess would be that any solution via the EFSF would in the end be preferable to Germany as compared to any Commission-led solution because this country has increasing doubts in the non-political character of the EU Commission with its alleged bias towards the Southern, e.g. Portuguese and Italian view.

If also the ECB under Mr. Draghi would be prepared to follow the approach proposed by Gros and Mayer (2011), Germany with its rule-based and price-stability oriented Bundesbank tradition would have to swallow the bitter pill that this change in character of the ECB is the price for strongly pushing through the only way to get away from the mess: governments of highly indebted euro area countries should continue to tackle the markets' crisis of confidence at the roots by pursuing the extremely difficult task of improving competitiveness and growth (Belke, 2011a).

Admittedly, bringing EMU sustainably back on track will only be successful if government debt and deficits are reduced substantially – optimally by national debt brakes democratically imposed by national parliaments. The recent financial and economic crisis has proven again that any concept of permanent deficit-spending and excessive debt will inevitably lead to the impossibility of debt rolling. A long-term oriented programme of debt reduction is a conditio sine qua non. However, debt reduction takes time not only in Greece. In order to avoid failure of EMU, it should thus be accompanied by a crisis management mechanism like the one described above which should not yet rely on euro bonds as correctly and repeatedly stated also by Mr. Draghi. A key condition for the introduction of euro bonds in a narrow definition is that public debt has first to be reduced to a sustainable level. But this condition is neither realized in the euro area as it stands nor is it credibly on the official agenda, at least for the time being. Instead, it has been watered down in Deauville in October 2010 (Belke, 2011a).

Seen on the whole, thus, I am not quite sure that the Gros and Mayer (2011) proposal will be an "equilibrium solution" in the polit-economic game just described because it would be against the short-term interests of the German government. However, it brings up the painful subjects that (1) credible commitments by all euro area governments to stop permanent deficit spending forever and to deliberately introduce waterproof debt brakes are probably not more than a fiction, and (2) if one would reject this proposal because it is very close to direct monetary financing of public debt, the only obvious alternatives to this proposal would be to acknowledge the end of the fiat money standard[5] and to head for fierce currency competition (ECB Observer, several issues) which, however, could contradict the necessity to go for more monetary policy coordination among the G20 (as argued later on in this paper).

One ultimate (purely academic?) solution would be to re-nationalize and de-politicize and economize the process of money creation in the Hayekian tradition (for a comparison of Friedman's constant money growth plan with Hayek's Competition of currency concept see Belke and Polleit, 2010, pp. 352ff.). But in order to be realistic, at least, this would imply for Mr. Draghi to set the ECB on track to compete for the assessment as the most stability-oriented currency area in the world in order to attract the confidence of international investors from China, Russia and oil-exporting countries currently on the brink of turning away from the US as a safe haven due to its obviously unsustainable macroeconomic policy mix (Belke and Polleit, 2011). This would immediately imply for Mr. Draghi when in office as ECB President to push for an acceleration of the exit from expansionary unconventional monetary policies even as a go-it-alone strategy and to cut the ECB's balance sheets down as fast as possible.

VII. Conclusion

Without the immediate installation of any sovereign default mechanism such as an EMF, the ECB would have to bear the burden. It would then risk degenerating to the "bad bank" of the euro area as timid investors would offload sovereign

[5]Anyway, it could be argued not only by monetary purists that also all alternatives such as public sector involvement (PSI) would imply exactly the same: using the printing press to finance public debt. PSI in the end means that the private sector is then bailed out in one way or the other by governments which then are bailed out by the ECB or directly by the central bank. Whether the Gros and Mayer (2011) proposal itself has an inflationary bias is still open to debate. The authors argue that EFSF money demand simply crowds out money demand by the private sector.

bonds with uncertain repayment values on the ECB's balance sheet. Investors understand that some countries protected by the installment of the ESFS and the EFSM these days will still have the potential to become insolvent and are not limited to alleged illiquidity.

Recent events have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programs and austerity packages risk lacking credibility and the SMP puts the balance sheet of the ECB at risk. What is more, only sovereign funds reveal the true opportunity costs to the initiators.

The most demanding task is to prevent the euro area from stumbling into a perpetuation of ESFS and the ESFM financial rescue packages from making countries unable to access the markets in the future. What is difficult to see at the moment is how, once started, it can stop. The preferred way out appeared to be the creation of an EMF. The European Stability Mechanism (EMS) agreed upon in March 2011 will be constructed in a way not too different from the EMF.

What is more, the ECB could contribute to sovereign debt consolidation by accepting (of course, after a transition period) solely bonds that are issued by those countries that have introduced upper bounds to debt levels as collateral. This proposal á la Martin Feldstein appears to be beneficial because imposing "debt brakes" and the resulting decrease in the interest to be paid should be in the national self-interest of the respective countries.

Convergence of interest rates within the euro area was also the result of rating agencies avoiding publishing stand-alone ratings of countries that would rightly exclude the difficult to quantify and politically biased convergence effects of sovereign bailouts. In terms of governance, rating agencies should be forced to proceed as it is now done in the case of the Deutsche Landesbanken for which the *Gewährträgerhaftung* has been abolished.

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