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## EMU 2.0 Drawing lessons from the crisis - a new framework for stability and growth

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## **EMU 2.0**

# **DRAWING LESSONS FROM THE CRISIS - A NEW FRAMEWORK FOR STABILITY AND GROWTH**

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### **Abstract**

This paper, drawing on the lessons from the sovereign debt crisis, tries to give answers to some key questions: Was the strategy and specific actions to cope with the crisis appropriate? Was the priority given to preserving financial stability justified? Are stability and growth objectives possible in EMU? What is the scope for national economic policy in the new policy framework? It emerges from the analysis that, after some initial weaknesses in policy action, decisive initiatives by EU authorities, supported by significant progress to strengthen further economic and financial governance and reduce macroeconomic imbalances succeeded in preserving the stability and integrity of the euro area. While the priority given by the EU policy action to financial stability was fully justified, it is also clear that robust economic growth is essential for durable financial stability and overall welfare. Policies enhancing both stability and growth are possible in EMU and some of them have started being implemented while others are at an advanced stage of development. There is ample scope for national economic policies which, if well-designed and properly implemented, will enhance the growth potential of member countries. However, legacy problems such as the excessive government debt burden in some countries must be resolved.

*Keywords:* Economic governance in EMU, the sovereign debt crisis, adjustment in a monetary union, European economic and financial integration, financial stability and growth, national economic policy in EMU

*JEL classification:* E42; E44; E52; E61; F32; F33; F41.

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## 1. Introduction

This paper is a follow-up to the May 2012 article<sup>1</sup> on “EMU sustainability and the prospects of peripheral economies” which, having analyzed the first set of economic governance reforms, predicted that they would succeed to contain and overcome the sovereign debt crisis. Almost three years later it is clear that, while the crisis was indeed contained, it has not, as yet, been fully overcome. In view of this situation, and drawing on the lessons from the crisis, this paper tries to give answers to some key questions:

- Was the strategy and specific actions to cope with the crisis appropriate?
- Was the priority given to preserving financial stability justified?
- Are stability and growth objectives possible in EMU 2.0?
- What is the scope for national economic policy in the new policy framework?

Decisive initiatives by EU authorities, supported by significant progress to strengthen further economic and financial governance and reduce macroeconomic imbalances, succeeded in preserving the stability and integrity of the euro area. At the same time, some weaknesses in policy action were corrected with a shift in focus towards improving the soundness of the banking sector and moving towards a banking union.

It is argued in the paper that the priority given by EU policy action to financial stability was fully justified. However, it is also clear that robust economic growth is essential for durable financial stability and, therefore, the creation of conditions for economic recovery and sustainable growth must be constant objectives of public policy.

It emerges from the analysis that policies enhancing both stability and growth are possible in EMU and include *economic rebalancing*, which will have broader positive implications than usually assumed, the *banking union* project, which is essential for financial stability and important for growth and new initiatives to achieve an *integrated internal market*. To the above should be added actions directly enhancing economic growth such as policies supporting

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<sup>1</sup> See Bank of Greece, Economic Bulletin No 36, April 2012.

private and public *investment* and more *growth-enhancing policies* at both central and national level.

Although the crisis has not yet been overcome and some parts of the new legislation have not yet been fully implemented, it can be argued that there is ample scope for economic policy at national level, as weaknesses in EMU's architecture have been largely corrected and systemic risks greatly reduced. However, legacy problems, such as the excessive government debt burden in some countries, must be resolved.

## **2. The emergence of the sovereign debt crisis and its management**

Shortcomings in EMU's institutional framework did not allow timely preventive action before the emergence of the crisis and, also, complicated corrective action when the crisis occurred. From the analysis of the overall management of the sovereign debt crisis and the specific action undertaken to contain and overcome it, useful lessons can be drawn for the design of public policy in the future at EU and national level.

***The sovereign debt crisis emerged in economies with sizable imbalances and structural weaknesses....***

The global financial and economic crisis of 2008-2009 was transformed in 2010 into a sovereign debt crisis in the euro area, hitting countries with sizeable macroeconomic imbalances and structural weaknesses. The crisis intensified in 2011 and the first half of 2012 threatening the stability and integrity of the euro area.

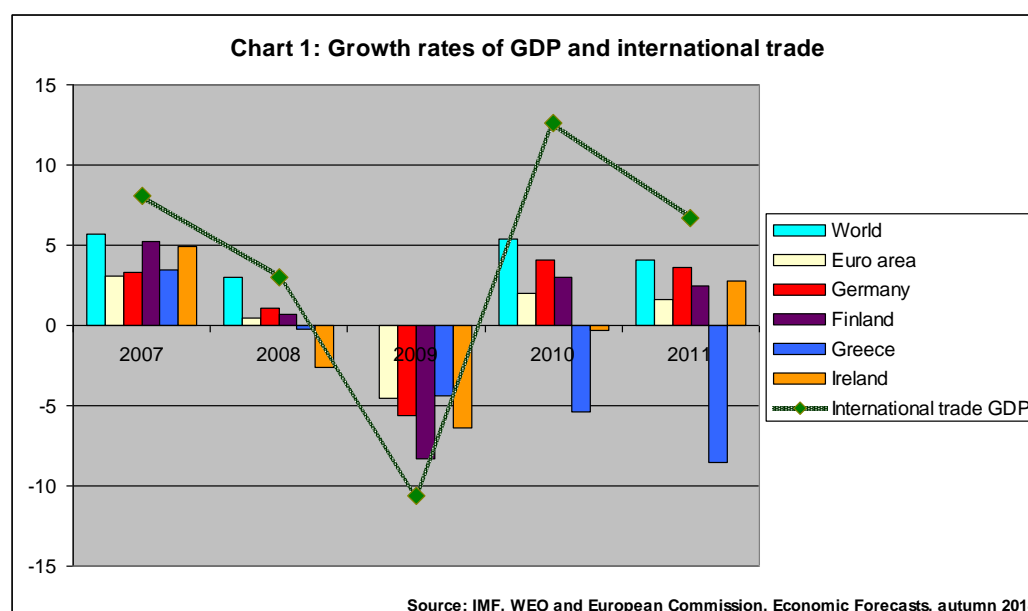
Both internal and external macroeconomic imbalances<sup>2</sup> had been the main source of difficulties in Greece and Portugal, while banking sector weaknesses were sources of fragility in Ireland and Spain, not least because the necessary restructuring of banks in those countries impacted negatively on public finances, notably in Ireland. It is noted that the fiscal deficit in Greece reached 15.2% of

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<sup>2</sup> Although both excessive deficits and surpluses are detrimental to the smooth functioning of a monetary union (and for the world economy more generally), it is obvious that internal and external deficits constitute a much higher risk factor for financial stability and require more immediate remedial action on the part of the economies concerned.

GDP in 2009 and government debt 126.8% of GDP. In Portugal, fiscal and external imbalances were significant (see Table 1 in Section 3, below) at the start of the sovereign debt crisis - though lower than those in Greece – but the very high private sector indebtedness (225% of GDP in 2009, compared to 122% of GDP in Greece) was contributing to financial fragility.

Greece was the first euro area country to be hit by the sovereign debt crisis in early 2010 followed by a number of other member states - Ireland and Portugal, in late 2010 and mid-2011, respectively, Spain<sup>3</sup> in 2012 and Cyprus in 2013. All countries faced serious weaknesses, different in each case, but with a common implication, difficulties in accessing international capital markets at normal financial terms. These economies, already seriously weakened by the global crisis, did not possess the necessary resilience and adaptability to overcome the sovereign debt crisis with their own means. Moreover, engulfed in the spiral of the crisis and its implications, they were unable to benefit from the recovery of the global economy and international trade in 2010, which followed the deep recession in 2009, as was the case of export-oriented economies with sound fundamentals, Germany and Finland, for example (Chart 1).



While Germany and Finland recovered rapidly in 2010, recording GDP growth rates of 4.1% and 3.0%, respectively, up from strongly negative growth

<sup>3</sup> The case of Spain should be distinguished from the rest of the programme countries as its difficulties concerned basically the banking sector and the financial support received (only from the EU and not from the IMF) aimed at helping the restructuring of that sector.

rates in 2009, economic recession in Greece deepened to -5.4% in 2010 and further to -8.9% in 2011. In Ireland and Spain, real GDP growth rates continued to be negative in 2010 but the recession was less deep than in 2009, while in Portugal it remained temporarily positive in 2010 but turned negative in the following three years. The euro area as a whole registered a positive growth rate in 2010 while the global economy recorded growth of 5.4%, up from 0.0% in 2009 and the volume of international trade in goods and services rose by an impressive 12.6% after a sharp fall (-10.6%) in 2009.

- The euro area economy was recovering strongly enough in 2010 from the deep recession in 2009. This suggests that a better diagnosis of the causes and nature of the crisis and, as a consequence, its more appropriate management<sup>4</sup>, including better designed EU/IMF economic programmes, could have led to the impact of the crisis being much less severe. Indeed, emerging evidence suggested that it was not just a fiscal crisis, as conventional wisdom at the start of the crisis thought, but one of a more diverse character, including an underlying banking crisis<sup>5</sup> in a number of member countries.

***Shortcomings in EMU's architecture did not allow timely preventive action and also complicated corrective action....***

There is a convergence of views among policymakers, academics and other analysts that shortcomings of EMU institutional framework did not prevent the accumulation of sizeable macroeconomic imbalances and structural weaknesses within the euro area in the first decade of EMU. Furthermore, it complicated corrective action to contain and overcome the sovereign debt crisis once it emerged<sup>6</sup>. O. Rehn, European Commission Vice-President, responsible for

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<sup>4</sup> O. Rehn argued, in an interview in WSJ, that "Euro-zone governments wasted two valuable years before creating a powerful bail-out fund to fight the currency bloc's debt crisis", Walt Street Journal, 29.6.2014.

<sup>5</sup> See Constancio V. (2013).

<sup>6</sup> The focus of this paper is the management of the crisis by the European authorities regardless of weaknesses and policy mistakes on the part of national governments. The rationale of this approach is that even if national weaknesses and mistakes did exist, EU institutions were expected to take appropriate action to remedy the situation and protect the stability and integrity of the euro area.

economic and monetary affairs and the euro until July 2014, summarised these shortcomings as follows<sup>7</sup>:

*“..it is indeed important to keep in mind why we have undertaken the comprehensive exercise of reinforcing economic governance. It is because our policy framework failed to prevent unsustainable fiscal and economic developments in many member states, with devastating consequences for their economies, and risking a financial and economic meltdown of the euro area as a whole. ... the failure is due to our incapacity to intervene early enough to prevent unsustainable developments and to enforce policy recommendations strictly enough when that was warranted according to the rules jointly agreed. In addition, the scope of the surveillance has been too narrow”.*

However, in addition to institutional shortcomings, there were also weaknesses in the application of economic and fiscal rules. EMU’s economic governance framework was certainly incomplete but not nonexistent: for example, the EU *“broad economic policy guidelines”* provided guidance for member states economic policies and the *Stability and Growth Pact* was functioning reasonably well most of the time, as the European Commission was vigilant in its role as the “guardian of the treaties”.

Two other factors seem to have played a significant role in the absence of effective preventive action. *Firstly*, EMU had fallen victim of its own success in generating growth and employment in its first decade and no obvious need, and pressure, was felt for corrective action in cases of unsustainable policies. *Secondly*, and related to the first, the reluctance of some large member states to respect the common fiscal rules or face the consequences conveyed a message of laxity with regard to these rules with serious medium-term consequences.

- Regarding the first factor, robust GDP growth and employment creation in the euro area - 18 million jobs were created in the euro area in the first nine years of EMU, 4 million more than in the USA - and easily-financed internal and external deficits led to an attitude of benign neglect. Until the emergence of the global crisis, there was no perception of a balance of

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<sup>7</sup> Rehn O. (2010)



payments constraint or funding risk for government debt. However, this perception was mistaken, as proved by events, and as was noted in earlier publications, analysing the provisions of the Maastricht Treaty<sup>8</sup>.

- A characteristic example of the second factor was the attempt of France and Germany, in 2003, to postpone fulfilment of fiscal rules which required a correction of excessive government deficits. The attempt was partly neutralised following recourse by the Commission to the European Court of Justice and the judgment<sup>9</sup> of the latter which led to the reform of the Stability and Growth Pact in 2005.

The above weaknesses, both institutional and operational, were to a large extent corrected by the adoption of new legislation, mainly the “six-pack” and the “two-pack” in 2011 and 2013 respectively, and the “fiscal compact”<sup>10</sup> by which the balanced budget rule, in structural terms, was introduced. Through the adoption of the new rules, surveillance and coordination of fiscal and economic policies were strengthened and the powers of the Commission to ensure the application of common rules reinforced, for example through the “reverse qualified majority rule” by which a Commission proposal is considered as accepted unless a qualified majority of the EU Council members are opposed to it.

### ***Interaction between the Greek sovereign debt crisis and the euro area crisis***

The Greek sovereign debt crisis and its management are crucial to understanding the dynamics of the euro area crisis, as

- Greece was the first member country in which the sovereign debt crisis emerged,

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<sup>8</sup> Already in 1993, a European Commission publication noted that “*In EMU...neither the external constraint, in its broader financial and economic sense, nor the need for stabilisation measures would disappear...on the contrary, precisely because the liquidity constraint is reduced, the risk of accumulated debt and insolvency would rise*”: see T. Papaspyrou, (1993).

<sup>9</sup> The ECJ in its judgement (Case C-27/04, 13.7.2004) annulled ECOFIN decision by which France and Germany were allowed to postpone the fulfilment of the 3% of GDP rule for government deficit but did not accept Commission’s argument that its initial proposal would prevail (in essence the Court rejected Commission’s argument that it could decide in the place of the Council). This judgment made necessary a compromise solution and led to the reform of the Stability and Growth Pact.

<sup>10</sup> Included in the “Treaty on stability, coordination and governance in EMU” (entered into force on 1.1.2013) by which the balanced budget rule was introduced.

- an appropriate EU financial support mechanism<sup>11</sup> did not exist and had to be created from scratch, while
- events were unfolding and uncertainty rising, threatening euro area's stability and integrity.

Evidence shows that there was a close interaction between the management of the Greek sovereign debt crisis and the euro area financial and economic crisis which was rapidly taking on a systemic character.

- On the one hand, uncertainties about the implementation of the Greek programme and risks of Greece's exit from the euro area, widely reported by international media, raised concerns about the sustainability and integrity of the euro area itself.
- On the other hand, controversies about key elements of the support mechanisms, for example the treatment of private investors on government debt (which led to the Deauville Agreement between France and Germany in October 2010) and doubts often publicly raised about the commitment of Greece's partners to fully defend its euro area membership, were adversely affecting the implementation of its EU/IMF economic programme.

“Mixed results” was how the European Commission characterised the outcome from the implementation of the first Greek economic programme - a statement reflecting a significant reduction in the fiscal deficit but at the cost of much deeper economic recession and much higher government debt than projected in the programme. This outcome necessitated a new loan and increased the uncertainties for Greece and the euro area.

As will be shown in Section 4 below, the renegotiation of the first Greek economic programme and agreement on a second EU/IMF programme in 2012 contributed to the stabilisation of the situation in the euro area, complementing

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<sup>11</sup> Article 122(2) of the Treaty on the functioning of the European Union could be used as a legal basis for granting financial assistance to member states in difficulties but only under certain conditions (“..difficulties caused by natural disasters or exceptional occurrences beyond the control of the member state concerned...”) and the amounts available were – and still are - limited (about 60 billion euros in total, corresponding to the maximum amount which can be guaranteed by the EU budget)

the decisive initiatives undertaken by EU institutions to ensure the stability and integrity of the euro area.

***The intergovernmental approach to integration: some merits but higher risks***

An important element of the crisis management at EU level but also of the European integration process more broadly, has been the tendency to rely on intergovernmental solutions, outside the legal framework of the EU.

The European support mechanisms (EFSF and ESM), the Fiscal Compact (incorporated in the “treaty on stability, coordination and governance in emu”) and the Single Resolution Fund of the banking union project are examples of this tendency. According to the view of several stakeholders this is not the best way to proceed, as it privileges the weight of large and influential countries at the expense of a more acceptable “Community approach” which would strengthen the relative weight of European Institutions, such as the European Commission, which is the guardian of the Treaties and assigned the duty to promote the common interest.

However, this intergovernmental approach may be seen as an inevitable second best enabling European integration to advance if a consensus to modify EU treaties cannot be formed. It is also true that the responsibilities of the European Commission were strengthened in some respects as, for example, in the economic and budgetary surveillance and in bank resolution decisions in the banking union project.

In conclusion, the intergovernmental nature of several major initiatives may not be a satisfactory development, but can provide a reasonable provisional compromise between the options of inertia and the movement ahead, provided that the intergovernmental treaties are eventually incorporated in the main body of EU legislation at a later stage.<sup>12</sup>

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<sup>12</sup> For example in the “Treaty on stability, coordination and governance in EMU” it is stated in article 16 that within five years from the entry into force of the treaty the necessary steps shall be taken ...with the aim of incorporating the substance of the treaty into the legal framework of the EU”.

### **3. A turning point in 2012 as ECB initiatives and a critical mass of reforms stabilised the euro area**

A turning point in the euro area sovereign debt crisis was reached in 2012 when it was realised that, in addition to the creation and activation of support mechanisms and strengthened fiscal and macroeconomic rules, decisive action was needed to neutralize the risks of euro area disintegration, break the vicious circle between banks and sovereigns and move towards a banking union.

*The commitment “to do whatever it takes to preserve the euro” was decisive...*

Indeed, in July 2012, the ECB President underlined in London the commitment that, within its mandate, “*the ECB is ready to do whatever it takes to preserve the euro*”<sup>13</sup>. In August, the ECB announced its readiness to undertake Outright Monetary Transactions (OMT) in secondary markets with regard to sovereign bonds in the euro area, and in September published details of the modalities for undertaking OMTs, aiming to dissipate “*unfounded fears about the reversibility of the euro*”<sup>14</sup>. In previous months, in order to alleviate the funding constraints experienced by banks, the ECB continued to supply funding support using longer-term refinancing operations with exceptional maturities. In particular, the two three-year longer-term refinancing operations that were announced in December 2011 had a significant impact in 2012 as they led to a net liquidity injection of around €500 billion<sup>15</sup>. More recently, in January 2015, the ECB announced a quantitative easing programme (“expanded asset purchase programme”) in order to address the risks of deflation

*....but a critical mass of economic governance reforms also helped....*

It should be noted that a critical mass of EU economic governance reforms, notably concerning euro area countries, and progress in fiscal and macroeconomic adjustment at national level, were crucial elements in making the ECB’s initiatives credible. In particular, conditional financial support by the ESM within an economic programme supplied the appropriate framework for an eventual activation of the OMT programme. Moreover, the adoption by the

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<sup>13</sup> Draghi M. (2012)

<sup>14</sup> ECB (2012a)

<sup>15</sup> ECB (2012b) Annual Report 2012, page 14.

European Council of a “plan towards a genuine EMU”<sup>16</sup>, with concrete steps to establish a banking union, provided a clearer long-term perspective for EMU and it was an essential element in regaining financial market confidence and stabilising expectations.

***... as well as a better understanding of the nature of the crisis...***

Moreover, there was a better understanding of the nature of the euro area crisis and a shift of focus towards improving the soundness and performance of the banking sector, strengthening its surveillance and breaking the vicious circle between banks and sovereigns. The determination to proceed towards banking union was the most visible sign of the new priorities.

Progress in economic adjustment and reform in the programme countries contributed significantly to the overall effort to strengthen financial stability in the euro area and enhance its growth potential. In particular, the re-negotiation of the Greek economic programme which was put onto a new and more sustainable path was a positive element in this joint effort.

More generally, economic policy in EMU was starting to be rethought, including in connection to EU/IMF economic programmes. An important impulse to the latter was the report and resolution of the European Parliament on the Troika and its operation (see below), in view of the elections for a new parliament in May 2014. This rethinking, while sticking to the need for sound macroeconomic and fiscal policies, includes a better articulated policy mix, of fiscal, financial and structural policies using effectively to this end the instruments put at the disposal of European institutions and national governments by the new economic governance framework. To this should be added initiatives towards more growth friendly fiscal adjustment favouring, for example, investment spending.

***...and significant adjustment and reform in member countries***

There has been considerable macroeconomic and fiscal adjustment in the euro area since the start of the global financial and economic crisis, in particular in countries implementing adjustment programmes. However, although “flow”

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<sup>16</sup> See Van Rompuy (2012)

imbalances were considerably reduced, “stock” imbalances continued rising as a percentage of GDP<sup>17</sup>, due mainly to weak economic growth.

**Table 1 Euro area “peripheral” countries: significant decline in “flow” imbalances but still high “stock” imbalances (% of GDP)**

	Flow imbalances				Stock imbalances			
	Gov. Balance		CA Balance		Gov. Debt		Net. Int. Inv	
	<u>2009</u>	<u>2014</u>	<u>2009</u>	<u>2014</u>	<u>2009</u>	<u>2014</u>	<u>2009</u>	<u>2013</u>
Greece	-15.2	-1.6	-13.2	-2.8	126.8	175.5	-86.4	-121.1
Ireland	-13.9	-4.8	-3.9	5.5	62.2	110.5	-92.4	-104.9
Portugal	-9.8	-4.0	-10.1	0.1	83.6	127.7	-107.9	-116.2
Spain	-11.0	-5.6	-4.3	0.5	52.7	98.1	-93.8	-92.6

Source: European Commission, autumn 2014 economic forecast and Alert Mechanism Report 2015 (2014 data: estimates).

After two years of recession in 2012 and 2013, economic recovery has been gradual but unequal across countries, although the gap in GDP growth rates between peripheral and core countries is closing<sup>18</sup>. The employment situation has been very diverse among member states, reflecting their unequal economic performance during the crisis, and the unemployment rate has been very high in countries severely hit by the crisis. Financial markets fragmentation has been receding, but very slowly in some parts of the euro area.

<sup>17</sup> See Lane P. and Milesi-Ferretti G-M. (2014) on the diverging developments of flow and stock imbalances after the crisis.

<sup>18</sup> It is noteworthy that according to the IMF autumn 2014 WEO forecasts, real GDP growth rates of “peripheral” euro area countries (such as Greece, Ireland, Portugal and Spain) in 2015 will be higher than those in “core” euro area economies (such as Germany, France, Austria and the Netherlands). Although this partly reflects the gradual closing of sizeable output gaps due to the crisis, it nevertheless tends to confirm the argument (see T.Papaspyrou, 2012) that peripheral economies, once they adopt a more sustainable growth model, can become the winners of the growth game in the euro area in the coming decades.

### *Significant fiscal adjustment but still high the debt ratio*

The general government deficit of the euro area as a whole was reduced from a peak of 6.4% of GDP in 2009 to 2.9% of GDP in 2013, a trend reflecting a fall in fiscal deficits in most member countries. However, the government debt ratio continued to rise, due mainly to weak economic activity, and is estimated to have reached 94.5% of GDP in 2014 from a low level of 64.9% of GDP in 2007. While the government debt ratio increased in all euro zone countries during the above period, its rise was particularly steep in those member states severely hit by the sovereign debt crisis. According to current forecasts<sup>19</sup>, the euro area government debt ratio is expected to peak in 2015 at 94.8% of GDP and start falling thereafter.

- The government debt ratio is a crucial factor in the effort to strengthen financial stability in the euro area and avoid a reversal and return to situations characterized by uncertainty and a crisis of confidence. The establishment of a falling trend in the government debt ratio in individual member states with high government debt and in the euro area as a whole should be a policy priority, through an optimal combination of fiscal adjustment and other financial operations (e.g. privatizations).

In this context, proposals<sup>20</sup> to focus primarily on the debt ratio, in an effort to simplify EU fiscal rules, have some merits. It is considered, nevertheless, necessary to continue targeting both the fiscal position and government debt, paying always particular attention to the dynamics of government debt, as the implications for financial markets and the economy can be significant.

### *Important but unequal progress in reducing macroeconomic imbalances*

The reduction in external macroeconomic imbalances was significant but asymmetric, as countries with current account deficits, notably those under economic adjustment programmes, achieved noteworthy adjustment, while in surplus countries, which did not feel the same pressure for adjustment, current account surpluses even increased as percent of GDP<sup>21</sup>: The current account

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<sup>19</sup> European Commission economic forecast, autumn 2014.

<sup>20</sup> See Mogadam (2014)

<sup>21</sup> As was already noted, although external “flow” imbalances i.e. the current account deficits were considerably reduced, external “stock” imbalances, i.e. negative net international investment position (niip) continued rising. This has been more clearly the case regarding current account

surplus in Germany was 7.0% of GDP in 2007 and remained as high as 6.9% in 2013 and in the Netherlands rose to 8.5% of GDP in 2013 up from 7.3% of GDP in 2007. As a result of these developments the current account surplus as percent of GDP of the euro area as a whole increased to 2.4% up in 2013 from 0.2% in 2007, a development which contributed to the appreciation of the euro against the major world currencies and in effective terms over the same period.

#### **4. EU/IMF economic programmes: analytical and institutional aspects**

EU/IMF economic programmes, implemented by a number of euro area member countries since the emergence of the sovereign debt crisis, have been an important part of the response to the crisis by the EU institutions and national governments<sup>22</sup>. It is, therefore, natural that the design, implementation and overall management of the programmes be the subject of examination and assessment by independent analysts and official bodies, such as Committees of the European Parliament who focus on the institutional and political aspects of the programmes.

##### ***Analytical aspects***

Although two euro area countries<sup>23</sup>, Ireland and Portugal, concluded their respective economic programmes successfully at the end of 2013 and in early 2014, respectively, - and have entered the “post-programme” monitoring (see below) - the discussion about EU/IMF economic programmes was dominated by the management and performance of the Greek economic programme. This is understandable due to the wider implications of the Greek programme (see Section 2 above) and because the implementation of the first Greek programme was marked by a number of weaknesses, as key targets were missed. The first

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surplus countries whose positive niip increased further, as flow imbalances remained practically unchanged.

<sup>22</sup> EU/IMF economic programmes were the necessary complements, by including economic conditionality requirements, to the financial support packages agreed with the countries concerned.

<sup>23</sup> Spain’s programme, concluded successfully in December 2013, was of a different character, as it concerned only the financial sector and lender countries were exclusively euro area members (there was no IMF participation). It is noted, however, that Spain is also subject to “post-programme” monitoring as the countries with fully-fledged economic programmes.



Greek economic programme was re-negotiated in 2012 and a second programme was agreed involving new macroeconomic and fiscal targets and a new loan agreement<sup>24</sup>.

Looking at the results of the implementation of the first EU/IMF economic programme for Greece and taking account of reports and studies by several independent analysts<sup>25</sup>, international institutions, notably the troika institutions, as well as the reports and resolution on the troika by Committees of the European Parliament, it appears that the main reasons behind key failures of the first Greek programme can be summarised as follows (although other, more technical, factors such as those related to the size of fiscal multipliers<sup>26</sup> may also be relevant):

- The lack of “national ownership” of the programme had been, and to a large extent continues to be, a serious drag on its successful implementation, as necessary structural reforms and adjustments cannot be easily accepted by society. It is noteworthy that even the government coalition parties who had agreed the programme used to describe it as a “necessary evil” that had to be implemented because it was requested by the troika.
- The second main reason concerns troika institutions: contrary to conventional wisdom, and prior expectations, the troika institutions, notably the IMF and the European Commission, had no experience of economic adjustment in a monetary union, in particular in cases of highly indebted countries (the ECB being a new institution with a specific mandate was not expected to have such an experience). In particular, although the IMF had an experience of over 150 economic adjustment

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<sup>24</sup> The second EU/IMF economic programme for Greece agreed at the euro area summit on 26.10.2011 and formally decided by the Eurogroup on 21.2.2012, involved new economic conditionality and the corresponding new loan agreement included an extension of loan maturities, lower interest rates and a number of other conditions favourable to Greece. An important part of the new programme and the new loan agreement - essentially a precondition for the new agreement - was the PSI (Private Sector Involvement) involving the reduction of the nominal face value of government debt held by private investors, the objective of which was to secure the decline of the Greek government debt to sustainable levels.

<sup>25</sup> See, for example, Gros (2014) and Pisani-Ferry (2013).

<sup>26</sup> See IMF, WEO, October 2012, Box 1.1. “Are we underestimating short-term fiscal multipliers?”

programmes, the adjustment practically always included sizeable devaluations of the currency, often of the order of 30% to 50%, something impossible in a monetary union. The European Commission likewise, though it had some experience in monitoring balance of payments loans, had no experience of adjustment in a monetary union.

On the first issue, the reasons for the lack of national ownership of economic programmes and ways to remedy the situation should be examined. Indispensable elements of any remedial action include transparency about the economic situation and avoidance of untenable promises and unsustainable policies by political parties. How might lack of national ownership affect the implementation of the programme? Usually it works both ways: weak commitment by governments to pursue necessary reforms and adjustments interacts and reinforces “resistance” by citizens to reforms perceived as unnecessary and unfair. On the basis of these findings, troika’s argument that missing targets of the first Greek programme are mainly due to inadequate commitment to reforms seems to have some basis, without fully explaining the huge divergence between targets and outcome.

Regarding the second issue, it was stated, explicitly and implicitly, on several occasions, by IMF officials that there was inadequate knowledge of the dynamics of adjustment in a monetary union. Indeed, there are reasons to conclude that there was inadequate knowledge about the adverse consequences on economic growth and, as a consequence on the debt dynamics, of internal devaluation. The requirement for “expenditure-reducing policies” and “expenditure-switching policies” for a successful external adjustment is well-known in the literature. A reduction in internal demand, notably through fiscal consolidation contributes to reducing domestic absorption liberating resources for export. Devaluation facilitates expenditure switching by making domestic production more price-competitive in foreign and domestic markets. Devaluation and internal devaluation may have the same objective, to reduce the relative prices of domestic goods and improve competitiveness, but would have very different side effects: devaluation increases domestic output and raises domestic price level and nominal income, and thus reduces the real burden of debt, while

internal devaluation reduces domestic output and prices and lead to a rise, and in some cases a sharp rise, in the government debt ratio, as was the case in Greece.

### ***Institutional issues***

Concerning institutional aspects, the resolution of the European Parliament states that *“The EU/ECB/MF “Troika” helped four EU countries through the crisis and prevented it from getting worse. But the flawed structure and working methods hindered national “ownership” and compromised transparency and accountability”*. The resolution recommends, as a first step, that there should be clear, transparent and binding rules of procedure and for the medium-term recommends a radical overhaul of the Troika, in which the IMF involvement would become optional, the ECB would be present only as an observer and the European Commission role would be taken over by a “European Monetary Fund”. The above recommendations seem sensible overall and could improve the management of the programmes with the following adaptations:

- The IMF could be associated to the programmes as a consultant, without providing funds and, thus, contributing only through its “authority of knowledge” status. The European Commission should have the overall responsibility for the design, implementation and management of economic programmes, being thus accountable to EU Council, the Eurogroup and, of course, to the European Parliament who may even impose sanctions on Commissioners in case of notable failures. As a consequence, the current diffusion of responsibility between the troika institutions will cease. The ECB could participate in the design and monitoring of the programmes to the extent that such a role is compatible with its mandate and its independence status regarding monetary policy<sup>27</sup>.

As for the creation of a European Monetary Fund, the idea should not be rejected a priori but there are certain shortcomings: it would add to the proliferation of European institutions and would create some confusion with the role of the ECB, notably in connection with the term “monetary”. The

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<sup>27</sup> The Opinion of the Advocate General of the European Court of Justice (14.1.2015) on the ECB’s Outright Monetary Transactions programme clarified the situation in this respect (provided that the ECJ will approve his position) by arguing that “...the ECB, if the (OMT) programme is to retain its character of a monetary policy measure, must refrain from any direct involvement in the financial assistance programme that applies to the State concerned”.

assumption of the key role by the European Commission has the additional advantage that a European institution also responsible for monitoring and ensuring the respect of European economic and fiscal rules and internal market legislation, will have also the responsibility for the design and implementation of economic programmes and be accountable for any errors and misjudgements.

## **5. Priority given to stability was justified but robust growth is also essential**

Taking account of the devastating effects on several member countries' economies and the rising risks of euro area disintegration provoked by the sovereign debt crisis, it can be safely argued that the priority given by the EU to financial stability, in the broader sense comprising sustainability of public finance and financial sector stability, was fully justified, despite some initial weaknesses in policy action which were corrected in 2012 (see above section 3).

Moreover, as the sovereign debt crisis has been contained but not yet overcome, financial stability must continue to be a top priority of policy action until the new economic governance architecture and institutions have passed the test of time. This requirement looks a bit "intimidating" but it should not be so. It only means that while new institutions and mechanisms are tested by financial markets and actions of important stakeholders - electorates, parliaments, national and European courts<sup>28</sup> - the issue of financial stability must be given particular attention in order to avoid disturbances and rising uncertainty which could be detrimental for both financial stability and economic growth.

As a result of policy initiatives and progress in adjustment and reform, financial stability in the euro area was strengthened steadily from the second half of 2012. The successful exit of Ireland and Portugal from their EU/IMF programmes, and of Spain from the EU financial sector restructuring programme,

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<sup>28</sup> For example, the European Court of Justice will have to rule on compatibility with EU law of ECB's Outright Monetary Transactions instrument following an initial examination by Germany's Federal Constitutional Court, in February 2014, of a case filed by a lawmaker and a group of German academics. According to the Opinion of the Advocate General of the ECJ, issued on 14.1.2015, the OMT programme is compatible, in principle, with the Treaty. The ECJ is expected to decide on this case in the first half of 2015 (usually the ECJ follows the opinion of the Advocate General).

and significant progress towards adjustment and reform in Greece, notably within the framework of the second programme, and more recently in Cyprus, are also parts of a positive picture.

However, important challenges remain. A crucial element in order to durably ensure financial stability is to achieve the stabilization and then the decline in high government debt ratios in several member countries and in the euro area as a whole. This is indispensable in order to avoid the risk of a reversal of the drive towards sustainable public finances, give a strong signal to financial markets about long-term fiscal sustainability and initiate a virtuous circle for the euro area economy. Therefore, care must be taken to ensure the sustainability of public finances even if agreement is reached, as it is currently requested by certain governments, to relax, provisionally or permanently, certain fiscal rules, beyond the degree of flexibility that already exists (see box 6.1 below).

Priority to financial stability does not imply that growth considerations are of secondary importance in EMU. On the contrary, in the medium to long term, robust economic growth is essential for both financial stability and overall welfare and should be a constant policy objective at central and national level.

It should be noted in this context that concerns expressed during the first two years of the sovereign debt crisis, notably by credit rating agencies, about risks to financial stability in a number of euro area economies and of the integrity of the euro area itself, were related essentially to their capacity to achieve robust enough economic growth - an essential factor for financial and fiscal sustainability - and less by their commitment to fiscal adjustment<sup>29</sup>. This aspect was obviously not well understood at the time.

The real challenge for European institutions and national authorities in the new EMU 2.0 era is to find the right balance between these two objectives so that stability and growth policies are mutually reinforcing.

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<sup>29</sup> See for example Standard & Poor's statement "Factors behind our rating actions on Eurozone sovereign governments", 13.1.2012 according to which "...a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating, as domestic demand falls in line with consumers' rising concerns about job security and disposable incomes, eroding national tax revenues". Also Moody's "Rating action: Moody's adjusts ratings of 9 European sovereigns to capture downside risks", 13.2.2012 stating that "The main factors of today's actions are...Europe's increasingly weak macroeconomic prospects, which threaten the implementation of domestic austerity programmes...".

## 6. Policies for stability and growth are possible in EMU 2.0

Policies enhancing both stability and growth are possible in EMU and most of them have started being implemented, while others are at an advanced stage of development. Such policies include *economic rebalancing*, guided by the implementation of the EU macroeconomic imbalance procedure, that is expected to have larger positive implications than usually assumed, the *banking union* project, an essential element of financial stability and financial integration, and new initiatives to achieve effective integration in the *European Internal Market* which is the most important asset in the effort to strengthen economic recovery and enhance the growth potential of the European economy<sup>30</sup>. The *single monetary policy*, aims to create uniform monetary conditions within the euro area by pursuing its price stability objective, contributes to financial stability and economic growth but also to the effective unification of the internal market by enhancing integration of financial markets.

To the above should be added policies *directly* supporting economic growth. They include policies to support *private and public investment*, indispensable for strengthening economic activity and enhancing Europe's growth potential, more *growth-enhancing policies* at both national and central level focused on structural reforms in labour and product markets and actions to improve the business environment, including a re-focusing of competition and industrial policies, and a more growth-friendly fiscal consolidation and *external trade and investment policies* based on openness and reciprocity.

Although most of the above policies have been in place for some time now, much more needs to be done at both the national level, where implementation of adjustment and reform has often been weak, and at the EU level, where a refocusing of economic policy is needed to enhance the productive potential of the European economy and promote real convergence.

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<sup>30</sup> An integrated internal market is also a key determinant of FDI. According to available studies (see Vetter, 2014) FDI would be particularly valuable for the euro area periphery in the current situation where the majority of domestic companies are financially constrained

The focus in this section is on some key areas which are essential for both stability and growth in the EU and the euro area and are also related to the new policy framework.

As a consequence, although financial stability, supported by credible institutions and appropriate policies, is a precondition for any successful initiatives to improve economic performance, it matters a lot how financial stability is achieved and maintained. The ECB's intervention in 2012 was decisive in helping to lower the yields of government bonds - and thus the borrowing cost of sovereigns but also of the whole economy - from the unsustainable levels they had reached at the peak of the crisis. However, this decision needs to be followed by consistent adjustment and reform effort to enhance the performance of the euro area economy.

***Economic rebalancing would have far-reaching, positive effects***

The objective of the “macroeconomic imbalances procedure”<sup>31</sup> - to prevent and correct excessive imbalances which may jeopardize the proper functioning of EMU - is expected to have positive effects for both financial stability and economic growth. Its relevance to financial stability is obvious, bearing in mind the adverse effects of the accumulated internal and external imbalances in the first decade of EMU. Positive effects on economic growth are also expected from this reform, as the obligation to contain macroeconomic imbalances will lead to policies seeking internal and external balance resulting, if successful, in lower external imbalances within the euro area - in particular in a reduction of the very high current account surpluses in some countries –and reduced current account surpluses *vis-à-vis the rest of the world*. Such a development is expected to contain euro appreciation against the main world currencies, a major concern of exporters in euro area countries.

Moreover, there is a political economy/institutional aspect to the rebalancing strategy: the containment of imbalances within the euro area would reduce the over-dependence of debtor on creditor countries, a situation which, combined with the tendency to rely on intergovernmental solutions in order to

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<sup>31</sup> Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances and Regulation (EU) No 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area.

cope with crisis-related problems (see section 2 above ), often implies difficult relations and tensions. Therefore such a development is expected to have positive effects on the cooperation between member countries and the functioning of the economic and monetary union.

***The banking union is essential for stability and important for growth***

Priority given by the euro area summit in June 2012 to a rapid advance towards banking union, as part of a broader plan to move to a higher degree of integration in EMU, was justified by the need to break the vicious circle between banks and sovereigns, which had led the sovereign debt crisis into a difficult-to-control downward spiral. It was also concluded at the summit that “*when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly*”, a provision aimed, precisely, to work in the direction of severing the link between banks and sovereigns as the cost of bank recapitalisation would not burden individual country’s public debt.

In December 2012 the European Council agreed on the key elements of the banking union and on the issue of direct recapitalisation of banks, under certain conditions, by the ESM. This political guidance was followed by the adoption of EU legislation in order to set up the main building blocks of the banking union: a *single supervisory mechanism*, which introduces a unified banking supervision in the euro area and other participating member states under the responsibility of the ECB, a *single resolution mechanism* with a *single resolution fund* which will ensure that if a bank faces serious difficulties, its resolution can be managed efficiently with minimal costs to taxpayers and the real economy. A system of harmonized national deposit guarantee schemes will be in place from 2015 and a *single system* for guaranteeing deposits is expected to come later.

- A well-designed and properly implemented banking union, besides being essential for financial stability, will be also important for economic growth, as a) re-integration of European credit markets would enable them to play fully their role in financing the real economy and b) repair of the monetary transmission mechanism will ensure that ECB’s low interest



rates be effectively passed on to those countries that probably need them most<sup>32</sup>.

The qualifications “well-designed” and “properly implemented” are important, as concerns have been raised about the time-horizon within which the banking union project will attain financial maturity and be fully operational, judged to be too long - although shortened to eight years compared to ten years initially proposed - entailing considerable risks if an emergency occurs, and the legal form the single resolution fund would take, i.e. that of an intergovernmental international agreement<sup>33</sup>, considered to imply legal and operational risks. Another criticism was that the project lacks in effect a public backstop<sup>34</sup> in the event of a really big crisis and in this sense cannot be a substitute for a genuine fiscal union as some suggest that it might be. Indeed, according to some authors a banking union can respond to most important and costly shocks, arising from financial boom-bust cycles, followed by financial crisis, such as the global financial crisis and the euro area sovereign debt crisis, making thus redundant a fiscal union<sup>35</sup>. However such a role would require that a banking union is equipped with an effective backstop capacity (which could take the form of a common deposit insurance scheme as in the USA)<sup>36</sup>.

Regardless of the validity of the argument about the necessity or not of a fiscal union and, as a consequence, of a high degree of political union in EMU, the banking union project presents a number of significant advantages: it benefits from strong and wide political support, its establishment is well-advanced and, centered on ECB supervision, it seems to fulfill the right conditions to play a decisive role in improving the stability and the efficient operation of EMU.

It should be noted, however, that the popularity of the banking union project is based to a large degree on the expectation that it could achieve very substantial improvement in the stability and operation of EMU without much

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<sup>32</sup> Asmussen (2013).

<sup>33</sup> It is stated, however, in the agreement that “the contracting parties’ objective is to incorporate the substance provisions of this agreement as soon as possible into the legal framework of the Union”.

<sup>34</sup> See Obstfeld (2013).

<sup>35</sup> Based on evidence from the USA, Gros (2013) argued that to ensure its stability, the euro area needs a strong banking union and not a fiscal union and, as corollary to the latter, he concludes that no political union is needed either in EMU.

<sup>36</sup> Some interesting ideas on this issue are developed in Gordon and Ringe (2014).

economic cost to the European taxpayer and with no political cost to governments in comparison to a move towards fiscal union which is currently rather unpopular in public opinion in several member states. Several analysts have expressed doubts whether the 55 billion euros which could be mobilized by the single resolution fund by the end of the transitional period for its maturity would suffice to meet all eventualities. It should be noted, however, that besides the 55 billion euros of the fund, there will be also the possibility of recourse to the European Stability Mechanism and to financial markets, in case of need, in order to acquire the necessary funds before recouping them from the banking industry ex post.

***An effective integration of the Internal Market would boost growth and employment***

A unified internal market is the most valuable asset of EMU, giving businesses and private persons the opportunity to benefit from a large integrated market of over half a billion people. A unified internal market is also a key factor for attracting foreign direct investment.

Financial fragmentation, as a result of the sovereign debt crisis, constituted a reversal of financial integration - and as a consequence a reversal of the drive towards a unified internal market - achieved over the past decades through the free movement of people, goods and capital, the free provision of services and, finally, by the introduction of the euro. It is therefore of the utmost importance to re-establish financial markets integration and achieve an effective integration of the European internal market which was supposed to be completed by 1992 but in many respects is still incomplete. But despite these reversals in the integration process, available evidence indicates that the benefits from integration in specific areas have been significant<sup>37</sup>.

- It is important for the EU institutions to mobilize efforts to achieve the policy objectives for which they have full responsibility and capacity to

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<sup>37</sup> According to the publication “Market reforms at work in Italy, Spain, Portugal and Greece”, European Economy 5/2014, data for the four countries confirms the large benefits of the EU’s Services Directive and the power of business environment reforms: reforms implemented by mid-2013 are estimated to boost labour productivity in the sectors affected by the Directive by around 4.3% in Portugal, 5.7% in Spain, 7% in Italy and almost 9% in Greece. Given that the directive covers an average of 40% of GDP in the four countries, the full economy-wide effects should be considerable.

act. According to the European principle of “subsidiarity” each level of authority (national-European) has to act in priority in the areas where it has more authority and competence. And although obstacles to the effective completion of the internal market are most often put by member states, the EU, notably the European Commission, as the guardian of the treaties, and the ECB as far as banks and payment systems are concerned, have the legal authority and operational capacity to achieve the objective of market integration.

There are signs that financial fragmentation, is receding<sup>38</sup> but we are still far from a normalization of credit conditions and a proper functioning of the financial system in several member states. As a consequence, the normalization of such conditions should be a priority for all authorities concerned.

The crisis underlined also the need to develop a *European capital market*, a sort of capital union in addition to banking union, and rely less on the banking system for the financing of the real economy, notably the business sector, as more diversified financial markets reduce the likelihood of borrowing constraints. It is a positive development that enterprises, mainly larger ones, in crisis-hit countries have turned increasingly to capital markets to fund their investment projects and overall activity in view of the difficult access to bank credit.

### ***Supporting public and private investment***

There is broad agreement among policy makers<sup>39</sup> and independent analysts that a significant increase in investment is necessary in order to strengthen the pace of recovery and enhance the growth potential of the European economy. There are currently investment shortfalls in virtually all countries and in the euro area in particular<sup>40</sup>, although the situation varies greatly among its member countries: investment, as percent of GDP, declined by about four percentage

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<sup>38</sup> See ECB (2014)

<sup>39</sup> See, for example, the conclusions of the June 2014 European Council where it is stated that “... the priorities we set for the Union for the next five years are to...invest and prepare our economies for the future by addressing overdue investment needs in transport, energy and telecom infrastructure as well as in energy efficiency, innovation and research, skills, education and innovation...”

<sup>40</sup> See Lagarde (2014).

points in euro area total but by much more, between 8 p.p. and 14 p.p., in the countries most severely hit by the crisis (Table 2).

**Table 2 Euro area: Investment spending (% of GDP)**

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Euro area	23.1	23.0	21.1	20.6	20.7	20.2	19.6
Greece	25.7	23.7	20.9	17.3	15.4	11.7	11.2
Ireland	27.6	24.2	19.7	15.8	14.5	15.6	15.2
Portugal	22.5	22.8	21.1	20.5	18.4	16.3	15.1
Spain	31.0	29.8	24.3	23.0	21.4	19.7	18.5

Source: European Commission, autumn 2014 economic forecasts, Statistical Annex.

The analysis of factors underlying this investment decline in the euro area indicates that the most significant causes have been weak economic activity and prospects for lower growth potential compared with the pre-crisis period, the need for economic restructuring and reduction of excess productive capacity in specific sectors, such as the construction sector - notably in Spain and in Ireland - , and the reduction of indebtedness by the corporate and household sectors.

Additional factors, related to the sovereign debt crisis, which have adversely affected public and private investment, are the decline in public investment in the effort to consolidate public finances, financial market fragmentation which adversely affected capacity to finance investment projects, and the high degree of uncertainty, probably the most significant factor in investment decline since 2009<sup>41</sup>.

The negative influence of most of the above factors has been diminishing in recent quarters, as economic recovery is gradually picking up, progress in economic governance and in establishing a banking union is reversing financial fragmentation and reducing uncertainty, while reduced macroeconomic and fiscal imbalances make less pressing the need for further fiscal consolidation, leaving thus space for a rise in public investment. Also, a change in the growth model in economies hit by the crisis, away from private and public consumption

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<sup>41</sup> See “Investment and investment finance in Europe”, EIB, 2013.

and towards investment and exports, along with a shift towards more productive investment, would increase domestically generated savings and avoid aggravating fiscal and current accounts<sup>42</sup>. Under certain conditions debt-financed investment projects could have large output effects without increasing the debt-to-GDP ratio<sup>43</sup>.

However, the investment recovery which started in the second quarter of 2013 has been slow and more direct initiatives are needed to support investment and growth in the euro area and in the EU more generally. In this context there were proposals to modify EU fiscal rules, by excluding government investment expenditure from the calculation of fiscal deficits within the Stability and Growth Pact, in order to encourage public investment (see box below).

Regardless of the treatment of public investment within the EU fiscal rules, it is clear that the bulk of the investment needed should come from the private sector, as public investment accounts, on average, for less than one fifth of total investment in the euro area. Action at EU level, using all available institutions and mechanisms can support both public and private investment by improving public infrastructures and creating synergies between public and private initiatives. Some action has already been undertaken at EU level and includes the following:

- An increase by €10 billion in the share capital of the European Investment Bank (EIB) in 2013 which would allow the EIB to finance investment projects up to an additional amount of €60 billion over three years;
- A clearer orientation of the multiannual EU budget 2014-2020 towards investment and infrastructure projects, thus helping the EU attain the “Europe 2020” objectives; and
- The plan of J. C. Juncker, new European Commission President, for investments of at least €315 billion over three years<sup>44</sup> by the combined action of several European institutions and mechanisms.

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<sup>42</sup> See Malliaropoulos (2014)

<sup>43</sup> See IMF, “Is it time for an infrastructure push? The macroeconomic effects of public investment”, WEO, October 2014.

<sup>44</sup> See European Commission Communication “An Investment Plan for Europe”, 26.11.2014 for further details.

- The ECOFIN Council emphasized as a key condition for fostering investment the nexus with structural reforms and the strong synergies between investment and the single market agenda and it has asked the Commission and the EIB to identify potentially viable investment projects of European relevance and to report to the Council by December 2014.

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**Box 6.1.: Proposals to modify EU fiscal rules in order to support public investment**

A number of proposals aimed to strengthen public investment suggest the modification of EU fiscal rules, excluding - temporarily or permanently - investment spending from the calculation of general government deficits in the excessive deficit procedure. This is a sensitive political and legal issue, but, also, one associated with economic and financial risks if it implies an increase in public debt as a percent of GDP. As a consequence, an eventual political agreement on this issue would preferably be of a provisional character, related to the achievement of a fixed target within a specified time period and accompanied by requirements for compensatory measures to ensure a falling public debt ratio. It should be noted in this respect that the treaty recognizes the special nature and importance of investment among the various components of public expenditure, stating that in the event of non-fulfilment of the requirements for budgetary discipline, the European Commission will have to make report which “*..shall take also into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the member state*”<sup>45</sup>.

- It may be useful to note that during the preparation of the Maastricht Treaty, in the early 1990s, the possibility of including provisions distinguishing investment from current spending (by applying the so called “golden rule”) was seriously examined but was finally rejected, not on the basis of economic reasoning but on the grounds that this could lead in statistical manipulations and distorted accounts.

However, even if the risk of statistical manipulation exists, it does not constitute a sound basis for excluding an otherwise sensible provision (if, indeed, it is considered as such) for the wrong reasons: obviously the right approach would be to improve

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<sup>45</sup> Article 126(3) of the “Treaty on the Functioning of the European Union”

statistical methods and procedures. After the emergence of the global and the sovereign debt crisis, the European statistical system has been much improved and is now in a position to proceed to the necessary controls if a political decision about the treatment of public investment is made<sup>46</sup>.

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As we have seen above, initiatives to strengthen investment are primarily based on a more intensive and intelligent use of possibilities within the existing policy frameworks as well as the creation of more appropriate instruments. Other academic proposals support a more massive use of financial resources in a “Marshall-Plan” type of action involving substantial amounts of EU funds to finance large investment projects in the south of Europe. An example of the latter is the proposal made by the European Policy Centre which includes “*a dedicated investment fund - a new Stability and Growth Fund of around 0.5% of EU GDP - aiming specifically to deliver investment for growth in countries unable to make the necessary investments themselves*”.<sup>47</sup> It is recognized in the above proposal that such an amount of funds is not available, as the EU medium-term financial programme 2014-2020 i.e. the medium-term EU budget, has already been agreed, but it is argued that the ongoing discussions around the fiscal capacity for the euro area could be an opening.

Although proposals implying massive, and currently unavailable, EU funding for investment seem unrealistic, they provide, nevertheless, an estimation of the needed resources for effective action to boost investment and growth, notably in peripheral countries, and also underline the limitations<sup>48</sup> of the current approach to support economic recovery.

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<sup>46</sup> It should be noted that the six-pack legislation adopted in 2011 takes into account more than in the past investment expenditure in deciding whether to place a member state in an excessive deficit procedure, but this may be possible only in limited cases without practical relevance (the deficit shall be close to the reference value and the excess over it be only temporary). Somewhat broader is the scope under the six-pack regulation to take into account investment expenditure in evaluating progress towards the medium-term budgetary objective.

<sup>47</sup> See Article by F. Zuleeg on “A New Deal for growth and jobs in the Eurozone revisited”, Brussels, 27.1.2014

<sup>48</sup> According to the said article, EU actions - including Transatlantic Trade and Investment Partnerships with the US, regional funds, industrial policy, further development of the single market or the digital agenda - will take time to implement and even longer to impact on growth. In addition, they are also likely to benefit mostly the strongest economies, which have the economic structure to maximize returns from more open and developed markets and can also access support more effectively.

**Foreign direct investment** is an obvious source of funds and entrepreneurial knowhow that would be particularly valuable, notably for the euro area periphery in the current situation as the majority of domestic companies are financially constrained and have problems accessing finance via conventional channels<sup>49</sup>. The completion of the internal market is expected to attract more FDI as historically there had been a strong correlation between FDI and progress towards a unified internal market.

***Mobilize EU institutions and mechanisms to support recovery***

Existing EU institutions, mechanisms and policies provide a vast array of channels for action which can be used in order to support recovery and enhance the growth prospects of the European economy, in particular of peripheral countries. They include:

- the *Europe 2020 Strategy* focused on mutually reinforcing actions to enhance growth and job creation;
- the *EU budget*<sup>50</sup>, radically reformed and oriented to growth-enhancing projects through the *EU Multiannual Financial Framework (2014-2020)*;
- the *European Investment Bank*, the largest multilateral lender and borrower in the world whose lending capacity was enhanced by the 2013 increase in its share capital, and the *European Investment Fund*, EIB Group specialist arm providing SME risk finance;
- the *European Commission roadmap* to meet the long-term financing needs of the European economy;<sup>51</sup>
- a *new competition policy* and a *new industrial policy* oriented to growth and job creation while ensuring a level-playing field for all business activity in the EU and promoting the effective integration of the internal market;<sup>52</sup>

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<sup>49</sup> See Vetter (2014).

<sup>50</sup> Although the EU budget accounts for only 1% of EU's GNI, and 2% of national public expenditure, its impact is bigger than these percentages suggest as its funds are mainly used in capital investment in specific areas. Moreover the share of EU budget financed capital investment in some peripheral economies is quite significant. See further analysis on this subject in Nunez Ferrer J. and Katarivas M (2014).

<sup>51</sup> See European Commission, press release 27.3.2014.

<sup>52</sup> See Juncker (2014) and plans to raise industry's weight in the EU's GDP back to 20% by 2020, from less than 16% today and Almunia (2014) on the role of competition policy in the post-crisis world.



- promotion of *openness in international trade and investment* as a general policy orientation also through negotiated agreements including reciprocity clauses where necessary;
- Ad hoc initiatives to support restructuring and economic recovery in economies severely hit by the crisis include *EU/IMF programmes under the guidance of the troika*, a procedure which will most probably be reformed (see section 4 above).

A strong position towards mobilizing EU institutions, mechanisms and policies to support public and private investment in order to create more growth and jobs was taken by J. C. Juncker, the President of the European Commission (see above, subsection “supporting private and public investment”). The Commission also provided further guidance on the best use of the flexibility that is built into the existing rules of the Stability and Growth Pact in order to strengthen the link between investment, structural reforms and fiscal responsibility<sup>53</sup>

## **7. Scope for national economic policy in the new institutional framework**

The scope for national economic policy in the new institutional and policy framework, following economic governance reforms, deserves to be examined carefully, as we are largely, here, in uncharted territory: the crisis has not yet been overcome and a number of important decisions have not yet been fully implemented, notably those concerning the banking union.

### ***There is ample scope for national economic policy within EMU 2.0...***

It can be said that there is ample scope for member states to set their priorities and apply their economic policies, while respecting macroeconomic and fiscal provisions and internal market rules, for example those referring to state aid. The new provisions relating to the prevention and correction of

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<sup>53</sup> See European Commission “Making the best use of the flexibility within the existing rules of the Stability and Growth Pact”, 13.1.2015

macroeconomic imbalances combined with strengthened fiscal rules and enhanced policy coordination within the European semester procedure have made the new policy framework more rigorous but also more safe than in the past. Such a development was agreed by member states in order to avoid a re-occurrence of past policy errors, such as the accumulation of internal and external imbalances

- The provisions of the new policy framework are not incompatible, as some commentators have argued, with the design and implementation of national economic policies. On the contrary, by preserving a sound economic and financial environment they provide the right conditions for properly designed national policies.

It is recalled that under the new fiscal rules - the requirement for fiscal balance, according to the Fiscal Compact - is measured in structural terms, a development implying that countercyclical fiscal policy is possible within the new framework, in case of external and internal shocks. At the same time excessive fiscal deficits and debt will be avoided, thus reducing the risk of destabilizing financial markets. The rationale of the new rules is that fiscal prudence in good times creates the scope for counter-cyclical fiscal policy in downturns.

*....which should enhance country-specific growth potential....*

The new economic and financial framework would enable member states to concentrate on their economic policy priorities, initiatives and measures free from concerns about the systemic stability of the euro area.

- However, the new framework will be more challenging as well-intentioned declarations about the need for “growth-enhancing structural reforms”, for “growth-friendly fiscal consolidation” and for policies supporting innovation and research and upgrading educational standards **will need to be given real content so that an optimal use of the new governance rules is achieved.** Herein lies the real challenge of the exercise, i.e. in elaborating and implementing effective policies within the new framework.

In practice, the priority action analyzed in section 6 above concerning policies and projects identified as beneficial to the whole European and euro area economy also give guidance for immediate action by member countries to enhance the growth potential of their economies. For example, economic rebalancing within the euro area would be achieved through member countries' efforts to orientate their growth path towards achieving internal and external balance. Also, member countries can contribute to the integration of the internal market, by implementing EU directives such as the services directive which has a significant growth potential according to relevant studies<sup>54</sup>.

*....with structural reforms as the main driving force...*

Current discussion about the need to strengthen domestic demand in several euro area countries and optimize economic policy co-ordination and the policy-mix at the euro area level – indeed valuable and relevant objectives at the current economic juncture – should not obscure the need for continuing efforts to implement structural reforms in the labour and product markets, and in the overall functioning of the economy and the public administration, in order to enhance the adjustment capacity and the growth potential of individual economies and of the euro area as a whole. In reality, these are not competing objectives, as better functioning markets facilitate the effectiveness of fiscal and monetary policy and the search for an optimal policy mix.

There is ample evidence about the relevance of structural reforms for improved economic performance. In the euro area, countries undergoing appropriate structural reforms, for example in the context of economic programmes, have already shown significant results: Ireland is the most visible recent case with a real GDP growth rate of 1.5% quarter-on-quarter and 6.5% year-on-year in the second quarter of 2014, while the prospects of the rest of the programme countries have also much improved.

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<sup>54</sup> Data for Greece, Italy, Portugal and Spain confirms the large benefits of the EU Services Directive and the power of business environment reforms: reforms implemented by mid-2013 are estimated to boost labour productivity in the sectors affected by the services directive by around 4.3% in Portugal, 5.7% in Spain, 7% in Italy and almost 9% in Greece. Given that the directive covers an average of 40% of GDP in the four countries, the full economy-wide effects should be considerable (see European Economy, 2014).

- Recent research, for example, published in the quarterly report on the euro area<sup>55</sup>, indicates that by using structural indicators of labour and product markets, scenarios in which part of the gap vis-à-vis best performers is closed, show large potential gains in growth and employment, raising output by 1.5% to 6% after five years and in the case of Greece by up to 15% after ten years.

The appropriate approach to structural reforms - sequence, effectiveness, fairness, political cost - has for a long time been the subject of investigation of economic theory and policy. However, the current economic juncture involving a new economic governance framework, a high degree of diversity in economic and employment performance and asymmetry in internal and, especially, external adjustment among member countries, makes the search for reliable answers to the question of how to operate structural reforms more timely than ever. A promising avenue is the identification of best practices reported in member states' annual reform programmes examined in the context of the European Semester.

As several euro area countries have terminated their EU/IMF programmes (see section 4 above) and others are close to such an objective - through, possibly, the use of “precautionary financial assistance” as an intermediate stage - key provisions of these mechanisms are examined in Annexes 1 and 2.

***...but legacy problems, such as the excessive government debt burden in some member states, must be resolved***

A pre-condition for the euro area and its member countries to enter the EMU 2.0 era without excessive burdens and uncertainties is to address with determination and economic rationality legacy problems from the first decade of EMU, amplified by the impact of the crisis.

The two most important legacies are the very high government debt as a percent of GDP and the very high unemployment rate in crisis-hit countries. The high unemployment problem should be addressed through appropriate policies

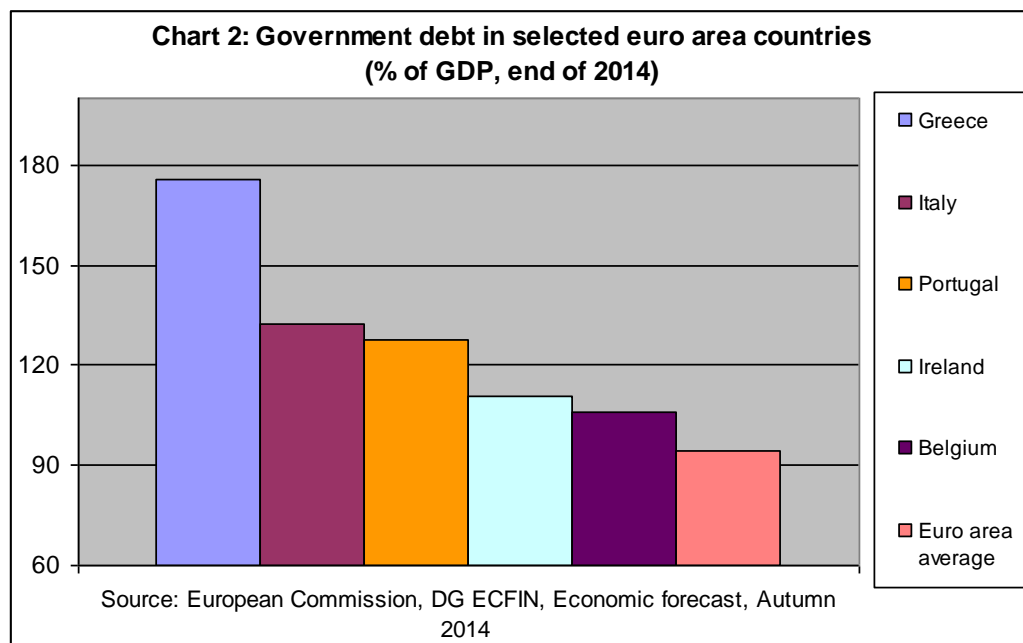
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<sup>55</sup> European Commission (2013)

and actions - some of them are analysed in this paper - and a positive response in terms of employment creation from the economies concerned.

This section will deal with the government debt problem which requires precise political, legal and financial actions.

Greece is the first euro area country that comes to mind when discussing problems of excessive government debt, because of the size of its debt and, also, as there is a Eurogroup decision<sup>56</sup> referring to the possibility of further measures towards ensuring debt sustainability. However, other euro area countries with high, and rising, public debt ratio may also face debt sustainability problems, unless a robust enough growth path is secured<sup>57</sup>.



It is important to note in analyzing the government debt issue that private analysts and European policymakers agree<sup>58</sup> that it would be in the interests of

<sup>56</sup> The Eurogroup agreed on 26.11.2012 to consider further measures, if necessary, to achieve debt sustainability so long as Greece complies with its obligations. According to the autumn 2014 European Commission forecasts Greece's general government debt will reach 175.5% of GDP in 2014.

<sup>57</sup> See Muenchau's article in the FT of 21.9.2014: "Italy debt burden is a problem for us all".

<sup>58</sup> It should be noted, nevertheless, that as far as Greece is concerned there are views suggesting that under the present financial support conditions no debt sustainability issues arise. In particular, Regling (2014), CEO of the European Stability Mechanism, argued that "Our loans to Greece, with an average maturity of 32 years, an interest rate of 1.5% (equal to our funding cost) and a 10-year moratorium on the payment of interest produces annual budget savings of €8.5 billion per year, or the equivalent of 4.5% of Greek GDP – year after year. Consequently, there is no debt overhang in Greece over the next 10-20 years, despite very high debt to GDP ratios".

the highly indebted countries, and of the whole euro area, to find a solution to this problem that is economically rational, financially sound and politically feasible.

- For example, the Institute for new Economic Thinking noted in a paper<sup>59</sup> that it is possible - economically and politically - to find a way out of the euro area crisis by dealing with two problems: a) the legacy costs of the initially flawed design of the euro area with a partial and temporary mutualisation of legacy debt; and b) fixing the design itself.
- Also, in the conclusions of the report<sup>60</sup> of the “expert group on debt redemption fund and eurobills”, mandated by the European Commission, it is stated that *“The current debt overhang is a key legacy problem and eliminating, or substantially reducing it, is important in order to establish the conditions for a credible no bail out regime and, ultimately, to ensure the normal working of the monetary union. It would, therefore, be in the general interest of all participants in EMU”*.

The Debt Redemption Fund (DRF) examined in the above mentioned report foresees a rather long period, about 25 years, during which the debt overhang defined as that part of government debt exceeding the 60% of GDP would be eliminated (the period may be shorter if a smaller part of the debt overhang were to be eliminated).

The idea of a Debt Redemption Fund was initially proposed by the German Council of Economic Experts, in November 2011, as part of a euro-wide debt reduction strategy. The key idea of the DRF is to provide a framework for bringing the euro area Member States’ public debt to sustainable levels by lowering their overall financing costs in exchange for additional commitments to fiscal governance<sup>61</sup>.

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<sup>59</sup> Institute for New Economic Thinking, INET (2012).

<sup>60</sup> European Commission (2014). The decision of the Commission to establish the Expert Group in July 2013 followed a commitment made to the European Parliament as part of an overall agreement on the “Two-Pack” economic governance legislation.

<sup>61</sup> The European Stability Mechanism could serve as a basis for establishing a DRF. This could be done – if political decision is taken to move towards this direction – by adding debt management to the securities issuing activity presently managed by the ESM. The ESM has all

This objective would be achieved through strict conditionality imposed on countries participating in the DRF, through a Pact accompanying its creation. The report recognizes that significant risks exist during the life of the debt redemption fund, notably the possibility that conditionality terms may not be respected - for various reasons - by participating countries, putting at risk the whole operation and its objectives.

Among the solutions on the legacy problem of debt overhang proposed by academics, political parties, national governments and European institutions, are an extension of maturities and a lowering of interest rates on outstanding government debt, clauses linking debt service to minimum economic growth rates, a write-off of part of the government debt, or a combination of the above. It is up to national governments and European institutions to decide about the most appropriate strategy and method. It should also be noted that some of the above solutions may be envisaged within the present legal and institutional framework while others may require treaty modifications, a more demanding and time-consuming procedure.

The above are basically ad hoc solutions to the legacy problem of high government debt. Other, more ambitious options such as the common issuance of public debt, under the term of “Eurobonds” or “stability bonds”, are based on the progressive pooling of sovereignty and responsibility as well as solidarity competencies to the European level<sup>62</sup>.

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#### **Box 7.1: How interesting could a Debt Reduction Fund membership be for Greece?**

On the basis of a rough estimation of the financial terms implied by a transfer of part of the government debt (i.e. the part above the 60% of GDP) to the DRF, the financial benefits of DRF membership are not obvious, on the assumption that the DRF becomes a reality<sup>63</sup>. Presently Greece is benefiting from very low borrowing terms and other advantages and the eventual financial terms under the DRF may not be better. It has also to be taken into account that the service of the part of government debt up to

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the necessary expertise and unused financial resources (which will need to be enhanced) to play such a role.

<sup>62</sup> European Commission (2012)

<sup>63</sup> The establishment of a DRF would require a change in EU Treaties.

60% of GDP would be assumed by each member country participating in the DRF at financial costs which are expected to be low - as responsibility of the largest part of the debt would be assumed by the DRF and the more rigorous governance framework of EMU 2.0 would ensure sound economic and fiscal policies – but on average not lower than the borrowing costs of the DRF.

However, there are probably other benefits of a more dynamic nature. DRF membership implies that Greece would become a normal member country as the others with government debt above the reference value of 60% of GDP, with all the direct and indirect advantages deriving from such “normality status”.

A more technical-financial element has to do with how financial markets and credit rating agencies perceive the size of government debt under the present situation and an eventual situation under which the part of the government debt above 60% of GDP is transferred to the DRF. Even if such a transfer would be made under rigorous conditions (the usual conditionality plus requirements that e.g. part of tax revenue to be automatically transferred to the DRF for debt repayment etc), that part of the debt will be transferred in the books of the DRF and removed from Greece formal debt obligations. This is important.

Another more political aspect has to do with the expected progress towards a “genuine EMU” according to the plan adopted by the European Council: the establishment of a DRF may be seen as part of a move towards the issue of Eurobonds as the integration process advances. It is important to be part of this process.

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## 8. Conclusions

From the analysis of the emergence and the management of the global and the sovereign debt crises useful lessons can be drawn for the design of public policy, at EU and national level, within the new economic governance framework. A number of suggestions in this direction are included in this paper.

Shortcomings in EMU’s institutional framework did not allow timely preventive action before the emergence of the crisis and complicated corrective action when the crisis occurred, while some weaknesses in the application of fiscal rules aggravated institutional shortcomings.



A turning point in the effort to overcome the sovereign debt crisis occurred in 2012, when ECB initiatives, supported by a critical mass of institutional and economic reforms, succeeded in neutralising risks of euro area disintegration. At the same time, the decision to create a banking union was designed to strengthen financial stability, financial markets integration and the European internal market.

It is a central point of this paper that the European strategy to preserve and strengthen financial stability was fully justified. There was ample evidence about this during the first two years of the crisis when uncertainty about financial stability in the euro area paralyzed attempts to revive the economy. However, it is also clear that robust economic growth is essential both for financial stability and overall welfare. Therefore the creation of conditions for economic recovery and sustainable growth must be a constant policy objective at EU and at national level.

Policies enhancing both stability and growth are possible in EMU and some of them have already started being implemented while others are at an advanced stage of development. They include *economic rebalancing*, guided by the implementation of the macroeconomic imbalance procedure, which is expected to have broader, positive implications than usually assumed, the *banking union*, a project essential for stability and important for growth, and new initiatives to achieve an effective integration of the *European internal market*. To the above should be added policies *directly* supporting economic growth. They include policies to support *private and public investment*, indispensable for strengthening economic activity and enhancing Europe's economic potential, more *growth-enhancing policies* at both national and central level.

What is the scope for national policies in the new economic governance framework? No easy answers exist, as we are here in uncharted territory: the crisis has not yet been overcome and some parts of the new legislation have not yet been fully implemented. With these qualifications in mind it can be argued that there is ample room for national economic policy which, if well-designed and properly implemented, will enhance the growth potential of member countries. The new policy environment is safer, as weaknesses in EMU's architecture have been largely corrected, but also more challenging: well-

intentioned but largely unfulfilled declarations about the need for “growth-enhancing structural reforms”, “growth-friendly fiscal consolidation” and for policies supporting innovation and research must be given real content in an optimal and sustainable way by mobilizing all available resources and expertise. Priorities identified at European level can provide guidance for action also at national level. However, legacy problems, such as the excessive government debt burden in some countries, must be resolved.

A final word refers to doubts often expressed about euro area’s prospects: the euro area’s strengthened economic and financial governance, sound economic fundamentals, including a robust export performance, and a largely unexploited potential of the internal market provide reasons to conclude that euro area’s prospects can be bright. But their realization requires some key elements: readiness to further improve economic governance, commitment to sound macroeconomic, monetary and financial policies, increased investment in physical and human capital, a positive attitude to innovation and reform and openness towards the rest of the world while protecting European interests. It requires also a commitment to and active participation in the European project with ideas, initiatives, proposals and concrete work towards achieving common objectives.

## **Annex: 1. Post-programme surveillance**

Regulation EU 472/2013<sup>64</sup> - which is part of the “two-pack” legislation having as objective to strengthen economic and budgetary policy coordination in the euro area - determines key elements and procedures regarding post-programme surveillance.

The regulation aims, also, to streamline the surveillance of economic and budgetary policies of euro area member states in application of EU legislation and the monitoring of the implementation of the conditionality in the context of the ad hoc economic programmes (either EU/IMF programmes or EU only programmes as that of Spain).

Specifically, in article 14 of the regulation it is stated that *“a member state shall be under post-programme surveillance as long as a minimum of 75% of the financial assistance received ... has not been repaid”*

and it is specified further that

*“The Council, on a proposal from the Commission, may extend the duration of the post-programme surveillance in the event of a persistent risk to the financial stability or fiscal sustainability of the member state concerned”.*

Regarding monitoring, it is stated in the same article that the Commission shall conduct in liaison with the ECB regular missions in the member state concerned and every six months shall communicate its assessment and shall assess in particular whether corrective measures are needed.

For the adoption of corrective measures the new, enhanced, role of the European Commission under the new economic governance rules becomes clear: *“The proposal from the Commission shall be deemed to be adopted by the Council unless the Council decides, by a qualified majority, to reject it within 10 days of the Commission’s adoption therefore”.*

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<sup>64</sup> Regulation (EU) No 472/2013 of the European Parliament and the Council of 21.5.2013, OJ L 140, 27.5.2013 “on the strengthening of economic and budgetary surveillance of member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability”.

## **Annex 2. ESM Precautionary financial assistance**

ESM precautionary financial assistance is foreseen in article 14(1) of the Treaty establishing the European Stability Mechanism<sup>65</sup>: *“The Board of Governors may decide to grant precautionary financial assistance in the form of a precautionary conditioned credit line or in the form of an enhanced conditions credit line...”*

On the basis of provisions of the ESM Treaty, the ESM Board of Directors have adopted detailed guidelines on the modalities for implementing the ESM precautionary financial assistance. Their main elements are as follows:

### *Objective*

The objective of precautionary financial assistance is to support sound policies and prevent crisis situations by allowing ESM members to secure the possibility to access ESM assistance before they face major difficulties raising funds in the capital markets.

### *Types of precautionary financial assistance*

Two types of ESM credit line are available: both can be drawn via a loan or a primary market purchase, have an initial availability period of one year and are renewable twice, each time for six months.

- **Precautionary Conditioned Credit Line (PCCL):** available to euro area member state whose economic and financial situation is fundamentally sound, as determined by respecting six eligibility criteria such as public debt, external position or market access on reasonable terms. The beneficiary country is obliged to respect these criteria after the PCCL is granted.
- **Enhanced Conditions Credit Line (ECCL):** access open to all euro area member states whose general economic and financial situation remains sound but that do not comply with some of the eligibility criteria for accessing a PCCL. The beneficiary ESM member is obliged *to adopt*

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<sup>65</sup> The Treaty establishing the European Stability Mechanism entered into force on 27.9.2012.

*corrective measures* aimed at addressing such weaknesses and avoiding any future problems in respect of access to market financing. It must also ensure continuous adherence to the eligibility criteria that were considered met when the credit line was granted.

#### *Procedure for granting precautionary financial assistance*

A request must be addressed to the Chairperson of the ESM Board of Governors, who will then entrust the European Commission in liaison with the ECB to assess whether the potential beneficiary country meets the required conditions and to evaluate its financing needs. A Memorandum of Understanding (MoU) will be negotiated and signed by the European Commission and a Financial Assistance Facility agreement detailing the financial terms and conditions of the assistance will be adopted by the Board of Governors.

#### *Activation of the credit line*

A credit line will be activated at the initiative of the beneficiary ESM Member. The Member will have the flexibility to request the draw-down of funds at any time during the availability period of the credit line according to the agreed terms.

#### *Enhanced surveillance*

When an ECCL is granted or a PCCL drawn, the ESM Member will be subject to enhanced surveillance by the European Commission for the availability period of the credit line. The scope of surveillance will include information regarding the beneficiary country's financial condition and developments in its financial system. On a request from the European Commission, the beneficiary ESM Member will also be required to carry out stress tests or sensitivity analyses to assess the resilience of the financial sector to various shocks and be subject to regular assessments of its supervisory capacities over the banking sector in the form of a peer review carried out by the relevant European Supervisory Authority.

The European Commission will conduct, in liaison with the ECB and European Supervisory Authorities as needed, and where appropriate the IMF, regular

review missions in the ESM Member under surveillance to verify progress made in the implementation of the adopted measures. It will communicate every quarter its findings to the Board of Directors and assess whether further policy measures are needed.

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