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Project "A test for European solidarity"

Solidarity within the Eurozone: how much, what for, for how long?

Sofia FERNANDES, Eulalia RUBIO

Foreword by Jacques DELORS

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Foreword by Jacques Delors

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Presentation of the project "A test for European solidarity"

Having put solidarity at the heart of the European Forum of think tanks held in Barcelona in September 2010, *Notre Europe* has defined a broader project on this theme, which allows it both to publish crosscutting reflection documents as well as Policy Papers covering different sectors.

With the economic and financial crisis having hit European countries in different ways since 2008, the EU is considering how far each country is responsible and what kind of solidarity is needed to overcome this challenge. Europeans have hastily set up solidarity mechanisms that their monetary union was lacking. Questions about legitimacy and the limits of European solidarity are now very much being asked out in the open.

They are all the more crucial as they generate tensions in national public opinions and among European political decision-makers. These tensions are not just about macroeconomic issues but have recently been about solidarity mechanisms put in place in the "Schengen area" and also relate

to the different extents of the other EU interventions, such as in the area of agriculture or energy.

In this context, *Notre Europe*'s work is inspired by the vision of Jacques Delors, who advocates articulating European policies around three key points that are more necessary than ever: "Competition that stimulates, cooperation that strengthens, and solidarity that unites." This vision, which embodied the Single Act, draws inspiration in particular from the 1987 report entitled "Stability, Efficiency, Fairness", in which Tommaso Padoa-Schioppa sets out how to push ahead with European economic and social integration in a balanced way.

Foreword

As 2012 gets under way, if we look at the development of the Eurozone over the past two years, we can draw two conclusions from our observations. The sovereign debt crisis has imparted a fresh thrust to the strengthening of the Economic and Monetary Union (EMU), fostering the kind of progress that would have been unthinkable until only shortly before the crisis. Yet despite this progress, the crisis has worsened over time because the responses adopted have been both belated and insufficient.

In the urgency of the moment, the lessons of the past have often been overlooked. Yet they can help us to better understand the issues involved in this crisis and to come up with suitable responses to it. In their analysis of solidarity in the Eurozone, Sofia Fernandes and Eulalia Rubio perform that task in urging us to revisit the past before turning our gaze to the future.

The solidarity and coordination issues implicit in sharing a common currency played a large part in the debates which preceded the establish-

ment of the EMU, and the authors remind us that the considerations of 20 years ago are still valid today. I was one of those, back in the 1990s, who argued that the EMU should be equipped with a strong economic pillar. In particular, I made a proposal in 1997 that the Eurozone be bolstered by an economic policy coordination pact. The idea failed to garner much support at the time, however, and we have had to wait for the sovereign debt crisis to expose the flaws in the EMU's construction for the issue to be added onto the agenda again.

In addition to the need to strengthen economic policy coordination – rather than mere fiscal surveillance –, the errors of the past (both individual and collective) leave us with little choice but to envisage an increase in solidarity if we are to overcome the crisis. The authors remind us that such solidarity is based not on generosity but on the member states' "enlightened self-interest" (if for no other reason than that they are interdependent) and on the defense of a shared project. There is no miracle cure for this crisis, despite what certain people suggest when they recommend that the European Central Bank become the EMU's lender of last resort. The interstate solidarity required to overcome this crisis comes at a cost, of course, but if the Eurozone were to break up, the cost – and the damage – would be far higher.

With this analysis firmly rooted in solidarity, Sofia Fernandes and Eulalia Rubio offer us a lucid vision of the crisis and make a clear distinction between the short-term and longer-term issues. They assess the potential benefits, as well as the risks, of any solution that involves progress in the crucial solidarity required among the members of the EMU, but at the same time they are quick to point out that greater solidarity cannot exist unless it goes hand in hand with greater responsibility on the part of each member state.

Jacques Delors, Founding President of Notre Europe

Executive summary

The first ten years of EMU passed by with no major debate on the solidarity implications of creating a common currency. Since 2010, however, the Eurozone debt crisis has forced member states to make some steps in the exercise of solidarity that were unimaginable just some years ago. This has prompted a sharp debate on what solidarity means in the context of the EMU and how much solidarity is needed to get out of the crisis. The aim of this Policy Paper is to shed light on these issues.

It starts by proposing a **conceptual distinction between two logics** driving solidarity within EU countries (section 1), **a logic based on reciprocity and a logic based on enlightened self-interest**, and by **discussing the interactions solidarity-responsibility and solidarity-cooperation**.

With the help of these conceptual tools, this Policy Paper then reviews **how the issues of solidarity were discussed at the moment of creating the EMU** and **how solidarity and coordination were practiced before the crisis** (section 2).

It then analyses (section 3) the **way solidarity has been exercised during this crisis**. **Various factors are identified as severely hampering** the efficacy of the EU solidarity efforts:

- the fact that the "enlightened self-interest" of helping other EMU countries was not evident at first glance,
- the absence of ready-to-use instruments to provide financial assistance to EMU countries in need,
- the existence of false ideas on the costs of solidarity influencing national public opinions,
- the dominant interpretation of the crisis as a result of individual countries' faults and mistakes (which has influenced the way of applying conditionality as well as debates on the reform of EMU governance),
- the failure to understand the systemic causes of the crisis,
- and the lack of a credible commitment to do "whatever necessary" to avoid an EMU country make default and thus an Eurozone break-up.

The Policy Paper finally puts forward some **reflections and proposals on the type and amount of solidarity needed** in the years ahead (section 4). A distinction is made between short-term and long-term solidarity challenges.

In the short term there is no magic, cost-free solution to the Eurozone's debt crisis. Neither a massive ECB intervention nor the private sector involvement into potential EMU debt restructuring is the easy, cost-free solution some want to believe. The first faces enormous legal and political obstacles and the attempts to apply the second have aggravated rather than resolved the crisis. The only way to get out of the crisis is by accepting that, during a certain period of time, there is a **need to make an extraordinary effort of "enlightened self-interest" solidarity**, with richer EMU countries helping the most distressed ones. This solidarity effort should be comprehensive, combining **measures to stabilise debt markets** (a credible "deterrent", such as the issuance of Eurobonds) with **action to help weaker**

EMU countries resume growth. Equally important, it should be credible at the eyes of the financial markets: the latter should be convinced that EMU governments are ready to do whatever necessary to prevent a Euro break up and that they have the means to do so.

Once the things will calm down, we should put an end to this extraordinary exercise of non-reciprocal solidarity. The EMU is not intended to be a permanent "transfer" Union, in which richer members transfer resources to the poorer ones on a regular basis. To prevent this to happen, however, it is essential to avoid pronounced intra-EMU structural imbalances in the future. This requires **re-visiting the conditionality and functioning of the EU cohesion and structural funds**. Apart from that, the EMU would be more resilient to new crisis if endowed with a **capacity to develop a concerted discretionary fiscal action** in exceptional circumstances as well as if equipped with **two EMU-wide insurance mechanisms**: an insurance mechanism protecting EMU countries from the risk of liquidity crisis and an EMU-wide insurance fund covering bank deposits. Concerning the first (an EMU liquidity mechanism), the Policy Paper argues that a well-designed system of Eurobonds could be an effective insurance arrangement covering all EMU countries from liquidity crisis, but that the latter is only possible under the hypothesis that all EMU countries significantly reduce their debt-to-GDP ratios in a medium term horizon and credibly commit to conduct responsible fiscal policies. As regards the second (an EMU bank insurance), the best option seems to be an insurance mechanism funded through premiums paid by the EMU banks and backed by a joint public guarantee from all EMU governments.

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Introduction

Since the start of the Eurozone sovereign debt crisis, the term "solidarity" has come to the fore of European Union (EU) political debates. Yet, there is much confusion with respect to what does solidarity mean in the context of the Economic and Monetary Union (EMU) and how much solidarity has been exercised so far. While some portray the various steps taken since 2010 as a "proof of EU solidarity", others question the use of this term to define the various measures adopted so far, by pointing out the strict conditions attached to the aid packages and/or at the fact that these rescues packages have not been driven by altruistic motivations but by self-interest calculus. The same confusion reigns with respect to how much solidarity is needed to exit from the crisis: some people consider that we have gone too far and warn on the risks of turning the EMU into a "transfer Union", whereas others believe that the only way to save the euro is by setting up an explicit and permanent solidaristic mechanism within the EMU countries (be in form of common sovereign bonds or other).

The present Policy Paper aims at shedding light on current discussions on the exercise of solidarity within the EMU. It starts in section 1 by clarifying the various rationales for inter-state solidarity within EU member states. The rest of the paper focuses on solidarity within the EMU. In section 2, we review how the issue of solidarity and coordination were discussed at the moment of creating the EMU and how they were practiced before the crisis. In section 3, we analyse the way solidarity has been exercised since the start of the crisis. Grounded on the analysis from sections 2 and 3, we then put forward some reflections and proposals on the type and amount of solidarity needed to exit from the current crisis as well as to build-up a sustainable and well-functioning EMU in the long term.

1. The different rationales for inter-state solidarity in the EU

The concept of solidarity is ambiguous. It can be used to refer to a moral value (the moral imperative to help someone in need) or to a contractual promise of mutual assistance linking the members of a community. This ambiguity is also present in the EU Treaties: while art. 2 of the Treaty of Lisbon cites solidarity as one of the EU's values, in other parts of the Treaty there are references to "mutual solidarity" and fair sharing of responsibility as a principle which has to govern relations between member states in certain domains (see i.e. art. 24 TEU[1] on external and security policies or art. 67 TFEU on freedom, security and justice)[2].

This dual meaning of solidarity captures the existence of two ways of conceiving solidarity within a group. These two conceptions of solidarity are well expressed in Durkheim's classical distinction between "mechanic"

1. TEU stands for Treaty on European Union and TFEU for Treaty on the functioning of the European Union.
2. For a discussion of the meaning of solidarity in the EU see Fabry, Elvire, "European solidarity: Where Do We Stand? Should We Foster It and How?", 2010 European Forum of Think Tanks, *Synthesis, Notre Europe*, June 2011.

and "organic" solidarity[3]. According to Durkheim, traditional societies are held together by "mechanic solidarity". Because these societies are small and homogeneous, members are all socialised in the same patterns and hold common values. Solidarity hence is emotional, and grounded on a shared identity (on the moral imperative of helping "one of us"). Modern societies, on the other hand, are held together by "organic solidarity". In these societies, members perform different roles, have a variety of experiences and hold different values. However, because they are interdependent, they must rely on one another if their society is to function effectively. In these societies, solidarity is functional rather than emotional. Members commit to mutual assistance because they know their fate is dependent on the others' fate. From this perspective, solidarity is not an act of altruism but a rational act driven by self-interest.

Inter-state solidarity in the EU is better understood in terms of Durkheim's "organic solidarity". In effect, while EU countries hold some common values, it is the awareness of being intimately connected and mutually responsible for the preservation of a common project that has prompted the development of inter-state solidarity arrangements all over the history of European integration. The existence of self-interest can be more or less easy to recognise. In this respect, a distinction can be made between two different rationales inspiring inter-state solidarity in the EU: a rationale based on direct reciprocity (I help the others so that they will help me in the future in case of need) and a rationale based on "enlightened self-interest" (I help the others because I know that acting in the interest of other EU members or in the interests of the EU as a whole ultimately serves my own self-interest).

The first (*direct reciprocity)* is the rationale inspiring the classical insurance-type schemes. Examples of this type of scheme at the EU level are the EU Solidarity Fund (which comes to the aid of any member state

3. Durkheim, Emile, *The Division of Labor in Society* [1893], New York: Free Press, 1997.

affected by a natural disaster) or the Lisbon Treaty's "solidarity clause" (according to which member states "shall act jointly in a spirit of solidarity if a member state is the object of a terrorist attack or the victim of a natural or man-made disaster", art. 222 TFEU). Through these schemes, EU countries commit themselves to reciprocal aid in face of a risk that is equally spread among member states. All EU countries are thus potential givers and receivers of help. The interest of those providing aid is clear and based on direct reciprocity (as the risk occurs randomly, today's provider of help can be tomorrow's beneficiary).

The second *(enlightened self-interest*) is the rationale inspiring the EU cohesion policy. In this case, solidarity is driven by the donor EU countries' conviction that helping the recipient countries ultimately benefits them. In particular, richer EU countries help poorer EU countries to develop their economies in exchange of their engagement to the process of economic integration – which in the short term reports more benefits for richer than for poorer economies – and because they realise the development of the poorer EU economies has positive economic returns for them (in terms of growing exports, growing investment opportunities or decreasing population inflows among others).

There are various aspects that distinguish these two logics of solidarity. In the first case (insurance-type schemes), the need for solidarity stems from the similarity within the members of the group – they are all confronted to the same risk. In the second case, solidarity is driven by the difference – the stronger/richer EU member states realise they need to help the weaker/poorer ones to secure the stability of the group and/or the viability of the common project. Insurance-type schemes are conceived as "last resort" instruments, to be activated only in exceptional circumstances when a country is affected by a negative event that is not under its own control (exogenous risk). Solidarity schemes based on enlightened self-interest do not necessary work in this way. In particular, the countries

receiving help are not necessarily seen as irresponsible from the cause of neediness that entitles them to receive help. Based on direct reciprocity, insurance-type arrangements are widely accepted by the members of the group. The exercise of enlightened self-interest solidarity, on the contrary, might be politically difficult, as national public opinions might have difficulties to see the benefits from helping other countries. Indeed, one might argue that the political support to exercise enlightened self-interest solidarity is ensured as far as the help is conceived as temporary: thus, for instance, support to EU cohesion policy is maintained because it is not seen as a permanent transfer of wealth within regions but as an instrument to help poorer countries in their efforts to converge to the levels of richer countries (thus reducing the need for solidarity in the future).

Table 1. Two types of inter-state solidarity in the EU

Rationale for inter-state EU solidarity	Ultimate purpose of the solidarity arrangement	Nature of the solidarity relationship	Practical and political implications
Direct reciprocity	Pooling a risk evenly spread across all the EU member states	Equal – all EU countries are potential givers and receivers of help	Tend to be permanent To be exercised in exceptional circumstances, only when a country is affected by some negative event that is not under its own control (exogenous risk)
Enlightened self-interest	Helping weaker/poorer EU countries in order to guarantee the cohesion and stability of the whole group and/or to ensure the latter's engagement in the process of economic integration	Unequal – the stronger/richer EU countries help the weaker/poorer ones	Tend to be temporary Countries receiving help are not necessarily seen as irresponsible from the cause of neediness that entitles them to receive help

Source: Sofia Fernandes, Eulalia Rubio.

The distinction between two logics of solidarity might seem irrelevant to understand what happens in the current crisis. Indeed, until now, all solidarity efforts have been driven by the logic of enlightened self-interest, with the "strong" EMU countries having a triple A debt helping weaker EMU countries. However, this might change in the coming future, as the crisis spreads to the core of the Eurozone and becomes more difficult to distinguish between "strong" and "weak" EMU member states. More importantly, the crisis has bluntly exposed how vulnerable all EMU countries are vis-à-vis the financial market as well as the limited capacity they all have to stabilise their economies, thus re-opening old debates on the appropriateness of putting into place an EMU insurance-type scheme.

In the coming sections, we will explore how these two logics of solidarity were discussed and analysed prior to the crisis and how and to which extent are they relevant in the current context. Before that, it is important to highlight two other general points concerning the exercise of inter-state solidarity in the EU.

The first concerns the relationship between solidarity and responsibility. As noted by Vignon[4], any solidarity act has as counter-part an element of responsibility from the country receiving the aid. In practice, this responsibility is assured through the establishment of some conditionality attached to the use of the aid. Conditionality serves two different, partly contradictory purposes: a constructive purpose (guaranteeing the most effective use of the aid deployed and inducing the country to undertake the necessary parallel reforms to get out from the situation of neediness) and a punitive purpose (making the aid provided as unattractive as possible to reduce the risk of moral hazard. i.e, the risk the recipient country behave irresponsibly in the future on the belief that it will be again helped in case of need). The success of a solidarity action depends very much on finding a right equi-

4. Vignon, Jérôme, "Solidarity and responsibility in the European Union", *Notre Europe Policy Brief*, No. 26, June 2011.

librium between these two logics of conditionality. In particular, punitive conditions attached to the aid should not be as high as to endanger the ultimate aim of the solidarity; that is, to help the country redress from a negative situation.

The second point concerns the relationship between two basic principles governing relations within the members of a group, solidarity and coordination. To a certain extent, one might argue that there is an inverse relationship between these two logics of action. In the case of insurance-type arrangements, coordination can help reduce the incidence of some risks therefore reducing the need to activate the insurance mechanism. Thus, for instance, more and better coordination in the fight against terrorism reduces the odds of a terrorist attack in an EU country, and thus the need to activate the Lisbon Treaty's "solidarity clause". In the case of solidarity based on enlightened self-interest, coordination can serve to diagnose, prevent and redress divergences within a group, thus reducing the need for solidarity-based-on-difference. As we will see in the following sections, this latter point is of particular relevance in the context of current discussions on solidarity within EMU countries, as current demands of solidarity partially stem from the lack of effective coordination in the years preceding the crisis.

2. Solidarity and coordination within the EMU: theory and practice before the crisis

2.1. The debates prior to the creation of the EMU

While being to a certain extent a natural consequence of the commitment to create an internal market without frontiers, the creation of the EMU in 1992 represented a quantum leap in terms of economic integration. The implications that this movement would have for national economies were intensively discussed during the years preceding the signature of the Maastricht Treaty. Many of them were taken into account in the analysis put forward by the so-called Delors Report, which set the blueprint for the creation of the EMU[5].

From a solidaristic point of view, there were two particular arguments at discussion.

5. At its meeting in Hannover on 27-28 June 1988, the European Council decided to entrust to a Committee chaired by Jacques Delors, then president of the Commission, the "task of studying and proposing concrete stages leading towards this union". Composed by twelve governors of the EEC Central Banks and three independent experts, the Delors Committee presented its report in April 1989.

The first concerned the impact of EMU on the weaker economies. While monetary integration would entail long-term benefits for all countries (in terms of more facilities for trade and protection against exchange rate risks) many people feared that, in the short term, transport costs and economies of scale would translate into a shift in economic activity away from the less developed towards the more advanced, and more competitive economies. To smooth this negative effect, the Delors Report recommended accompanying the creation of the EMU with a strengthening of the EU cohesion policy.

The second issue concerned the impact of EMU on national governments' capacity to stabilise their economies. While the establishment of a monetary union eliminated exchange rate uncertainties and risks (something which was regarded as a highly positive move after the crisis of the European Monetary System in 1992-93), it also removed national governments' capacity to use exchange rate as an instrument to stabilise their national economies in case of suffering a country-specific shock. In the early 1990s, most analysis regarded this loss of the exchange rate mechanism as problematic. While countries had the possibility to resort to "internal devaluation" (adjusting to shocks through changes in prices and wages) this option was considered unrealistic in the event of temporary shocks, given the short-term rigidity of wages and prices formation. Against this background, many consider essential to equip the EMU with an insurance-type mechanism to provide temporary and conditioned financial assistance to countries in the event of an asymmetric shock. The proposal of creating such a mechanism was evoked in the Delors Report[6], and it was

6. "In order to reduce adjustment burdens temporarily, it might be necessary in certain circumstances to provide financing flows through official channels. Such financial support would be additional to what might come from spontaneous capital flows or external borrowing and should be granted on terms and conditions that would prompt the recipient to intensify its adjustment efforts" (Delors Report, p. 19).

seriously discussed and analysed during the early 1990s, both by independent economists and by the services of the European Commission[7].

In parallel to these debates on solidarity, there were discussions on the type and degree of policy coordination required within the EMU countries. Three different cases for coordination were identified.

The first was related to the need for fiscal discipline. It was unanimously recognised that, in a common currency area, a default on public debt by one of the members would have catastrophic consequences on the other members' economies. Besides, fiscal expansionary policies could have negative cross-border effects through their impact on the European Central Bank (ECB) policy. For all these reasons, most experts recommended establishing upper limits on public deficits and debts. Others were skeptical on the effectiveness of such limits, and recommended instead the establishment of a credible "no bail-out" clause into the Treaty[8].

The second case for coordination was of Keynesian inspiration. In the early 1990s, the role of discretionary budgetary policies as a tool to stabilise the economy was widely accepted. In coherence with this, many people called for a more "qualitative-type" coordination of national fiscal decisions, well beyond the setting of upper limits to deficits and debts. This coordination was considered a necessary pre-condition to give the

7. The role of EU public finances in cushioning asymmetric shocks was seriously explored in two influential reports on EMU published by the European Commission in the early 1990s, the famous "One Market, One Money" Report (1992) and the "Stable Money, Sound Finances" Report (1993). In this latest report, an independent group of economists entrusted by the Commission to examine the role of public finances on the EMU concluded the following: "The group shares the view of much of the literature on EMU that there is a strong case for a Community role in assisting member states to absorb severe specific shocks. This is in order to compensate for the loss of the exchange rate as an adjustment instrument and for the loss of an independent monetary policy, and should help to prevent longer-lasting economic deterioration which could increase the pressure for greater redistribution. It should also make it easier for member states to respect fiscal discipline" – European Commission, "Stable Money, Sound Finances – Community Public Finances in the Perspective of EMU", *European Economy,* n° 53, 1993, p. 6.
8. Eichengreen (1990) cited in Pisani-Ferry, Jean, "Only One Bed for Two Dreams: A Critical Retrospective on the Debate over the Economic Governance of the Euro Area", *Journal of Common Market Studies*, Vol. 44, No. 4, 2006, pp. 823-44.

EMU the ability to develop a concerted fiscal response in case of a shock affecting the whole EMU area.

Finally, the third case for coordination stemmed from the existence of interdependencies and policy spillovers between EMU economies. Although the establishment of a single currency was expected to deepen the degree of economic integration within the EMU countries (by facilitating intra-EMU trade flows and the mobility of factors), this was not supposed to entail a process of full convergence within EMU economies. Given the level of interdependency between EMU economies and national economic policies, many analysts considered essential to have regular policy exchanges and some form of policy coordination to prevent negative cross-national spill over effects and to identify and redress potentially dangerous intra-EMU imbalances.

The Delors Report recognised all three cases of coordination. While calling for the establishment of binding rules on public deficits and debts, it also considered essential to closely coordinate fiscal policy decisions "to design an overall fiscal stance for the Community as a whole", as well as to submit all national macro-economic policy decisions into a broader framework of coordination "to limit the scope for divergences between member countries". With respect to this latter point, it is interesting to note that the Report was rather skeptical as regards the spontaneous convergence that would entail the creation of a single currency. The experts of the group feared on the contrary that, "with parities irrevocably fixed, foreign exchange markets would cease to be a source of pressure for national policy corrections. Moreover, the statistical measurement and the interpretation of economic imbalances might become more difficult because, in a fully integrated market balance-of-payment figures, (...) would no longer play a significant role as a guidepost for policy-making"[9].

9. Delors Report, p. 17.

2.2. Solidarity and coordination at work: assessing the first decade of EMU

The creation of the EMU was enshrined with the signature of the Treaty of Maastricht in 1992. The Treaty established that the launch of the euro should be no later than January 1999. Only those countries fulfilling certain macro-economic conditions (the so-called "Maastricht criteria") would be invited to join the EMU at that time. To contain the risk of sovereign debt default, member states convened to include a criterion related to public finances among the "Maastricht criteria". It was agreed hence that countries entering the EMU should present a debt-to-GDP ratio no higher than 60 percent and a deficit equal or less than 3 percent. However, as the debt ratio of several member states exceeded 100 percent of GDP in the mid-1990s, in political negotiations the debt criteria was finally weakened: the sustainability of public finances was hence to be basically assessed on the basis of the 3 percent deficit criteria[10].

Apart from setting the calendar for the launch of the euro, the Maastricht Treaty introduced some provisions related to the exercise of solidarity and coordination within the EMU. Concerning solidarity, the proposal of creating an insurance-type mechanism to help countries temporarily in trouble was totally discarded. In contrast, the solidarity needs stemming from heterogeneity were addressed: the Treaty created a new cohesion instrument (the Cohesion Fund) designed to help the poorest countries due to join the EMU (Greece, Portugal, Ireland and Spain)[11]. This was complemented with a doubling of the amount of funding devoted to EU cohesion during the period 1994-1999 which was approved in December 1992 (through the so-called "2nd Delors Package").

10. It was agreed that countries having a debt ratio higher than 60 percent of GDP could be accepted if they proved that the ratio "was approaching the reference value at a satisfactory pace".
11. It should be noted that the Cohesion Fund was originally conceived as a temporary instrument for the period 1994-99. It was designed to help those countries whose GDP level was below 90 percent of the EU average and which were applying a convergence programme to join the EMU In 1999, in view of the enlargement to 10 new member states and the still weaker situation of some EMU countries, the European Council agreed to maintain this instrument for the following budgetary period.

As respect to the issue of coordination, the negotiations of the Treaty put into evidence a clash between the positions of Germany and France. On the one hand, the German government conditioned its support to EMU to the establishment of strict fiscal discipline rules. However, it was reluctant to any other type of coordination, its vision being that the costs of coordination would outweigh its benefits and that, provided everyone "puts its house in order", independent policy-making was preferable. On the other hand, the French were not against the establishment of fiscal discipline rules. Yet, they insisted on the need to counter-balance the powerful independent ECB with a sort of "economic government" for the EMU, the latter meaning more power to the ECOFIN to coordinate national fiscal and macro-economic policies.

The Treaty of Maastricht ended with a compromise between these two visions. The German position was satisfied with the introduction of Art. 104c TEC[12], which stated that "member states shall avoid excessive government deficits" and gave the Council the right to bring actions against governments breaching this rule. At the request of Germany, this article was complemented with the introduction of a "no bail-out" clause into the Treaty (Art. 104b TEC) explicitly forbidding the Union to help an EMU country failing to meet its financial obligations[13]. The French position was reflected in Art. 103 TEC, which stated that member states should regard their economic policies "as a matter of common concern" and which gave the Council the right to adopt Broad Economic Policy Guidelines and to conduct multi-lateral surveillance to ensure closer coordination of economic policies.

12. TEC stands for Treaty establishing the European Community.
13. Art. 104b TEC, "The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any member state, without prejudice to mutual financial guarantees for the joint execution of a specific project".

The equilibrium between the "French" and the "German" articles was altered in 1997 when the German government forced the introduction of a "Stability Pact" (later on renamed "Stability and Growth Pact" – SGP) to strengthen art. 104 TEC provisions on fiscal discipline, in particular by entitling the Council to set up sanctions for countries exceeding the 3 percent annual deficit threshold. Despite some voices in favor of making a parallel effort to strengthen art. 103 TEC provisions[14], the latter did not happen. The coordination of macro-economic policies was hence to rely on the formulation of vague common guidelines (the Broad Economic Policy Guidelines – BEPGs) and the possibility for the Council to formulate non-binding recommendations to those countries violating the BEPGs.

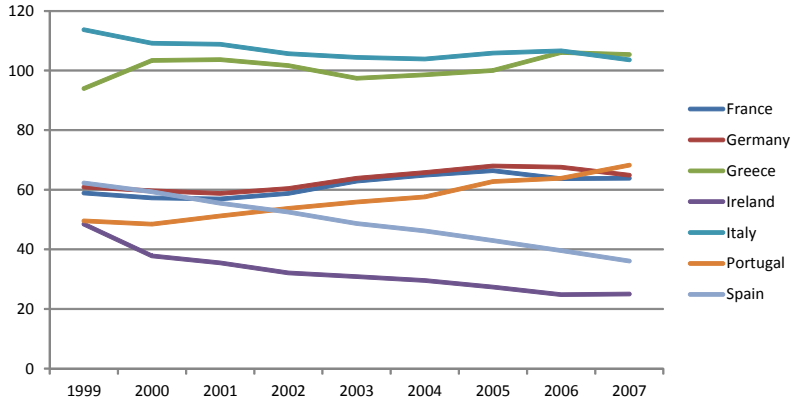
In January 1999, the euro was introduced in non-physical form. Eleven countries became members of the EMU, and were joined two years later by Greece. During the first decade of existence (1999-2009), the EMU functioned relatively well. While the average growth rate was not spectacular, job creation outpaced that of other mature economies, inflation and interest rates remained low and the euro gained prestige as an international currency. However, from the perspective of solidarity one can see, in retrospect, that there were some worrisome developments and some policy failures and deficiencies in the governance of the EMU that laid the foundations for the current crisis. Three particular issues merit to be highlighted.

The first concerns the developments in government debts. As said above, the main rationale to set up fiscal discipline rules was to avoid the risk of a sovereign default, considered highly dangerous in a currency area. During the run up to the EMU, countries had done important efforts to consolidate their public finances, under the menace of not entering into the EMU. However, once in the EMU, consolidation efforts were relaxed. As

14. One of these voices was that of Jacques Delors, who at that time had just quitted the European Commission. In August 1997, the former President of the European Commission put forward a proposal to concretise and strengthen Art. 103 TEC provisions through an "Economic Policy Coordination Pact".

shown in graphic 1, from 1999 until 2007, the average public debt ratio in the Eurozone declined only marginally, and even increased in some EMU countries such as Greece and Portugal, but also in Germany or France.

Graphic 1 - Debt-to-GDP ratios in selected Eurozone countries from 1999 to 2007



Source: Eurostat.

This lack of progress towards sound public finances was the result of two factors. The first was the conceptual and structural pitfalls of the SGP. Based on nominal deficits rather than cyclically adjusted deficits or debt ratios, the Pact proved to be ineffective in inducing countries to reduce their debt ratios during the high growth periods (1999-2001, 2005-2007)[15]. During these periods, increased levels of activity and high tax receipts made easy for countries to satisfy the 3 percent deficit criteria. However, many of them did it pro-cyclically, profiting from exceptional revenues to finance tax cuts instead of using it to reduce the debt burden, and very few undertook structural reforms on their age-related spending to ensure the long-term sustainability of their public finances[16]. The second factor was the fact that financial markets did not differentiate across Eurozone public bonds,

15. The reform of the SGP in 2005 tried to correct this by placing more attention to cyclically-adjusted positions. However, this failed to change the pro-cyclical tendency of many EMU countries and very few profited from the favourable economic context of the 2005-07 period to consolidate their public finances.
16. Apart from this conceptual pitfall, the credibility of the SGP was seriously undermined in 2003, when France and Germany blocked its strict implementation after breaching the 3 percent threshold for deficits.

treating all EMU sovereign debts as equally safe. As noted by Buiter and more recently by Boone and Johnson[17], this lack of differentiation probably reflected the financial markets' perception that, despite the "no bail-out" clause, EMU members would save a country in case of being at risk of default[18]. Thus, one might say that there was already an implicit solidarity arrangement within EMU countries as regarding sovereign debts: highly indebted EMU countries enjoyed low costs for servicing their debt because they profited from an implicit guarantee from the rest of EMU countries.

Apart from the trend in public debt ratios, a second worrisome aspect was the growing divergence among EMU countries. Since the early 2000s, current account positions widened significantly across Eurozone members, with some countries presenting a sharp deterioration of their current account deficits (Greece, Portugal, Spain) and others rising surpluses (Finland, Germany, the Netherlands). Two factors were the drivers of these divergences. On the one hand, since the launch of the euro, the combination of an EMU-wide nominal interest and higher-than-average national inflation rates translated into a significant fall in real interest rates in the poorer EMU economies. This fuelled a massive inflow of capital from the rest of the EMU into these economies, which in turn lead to an easing of credit constrains, an increase in credit-driven private consumption and, in certain countries, a boom in real estate investment. On the other hand, external deficits reflected the growing divergence in trade performance between poorer and richer EMU economies, which resulted from the combined effect of some richer EMU countries' efforts to improve their cost competitiveness and the lack of parallel reforms in those EMU economies with large external deficits.

17. Buiter, Willem, "The 'Sense and Nonsense of Maastricht' Revisited: What Have we Learnt about Stabilization in EMU?", *Journal of Common Market Studies*, Vol. 44, No. 4., 2006, pp. 687-710; Boone, Peter and Johnson, Simon, "Europe on the Brink", *Peterson Institute for International Economics, Policy Brief*, No. 11-13, July 2011.
18. As Boone and Johnson rightly point out, this market perception was not spontaneous but induced by some structural flaws in the functioning of the EMU. Above all, there was the practice of the ECB to treat all EMU sovereign debt equally by accepting it as collateral in the so-called REPO operations (operations to provide new financing to banks).

Although the risks that entailed this widening current account positions were well known (in the mid 2000 various reports from the Directorate General for Economic and Financial Affairs (DG Ecfin) and the ECB alerted on the dangerous consequences of these growing imbalances), nothing was done to correct this situation. During the 2000s, the Council went on issuing general recommendations in form of BEPGs but did not dare to single out individual EMU countries and ask them specific policy corrections. In discharge of the Council, one should add that the latter had only the capacity to issue non-binding recommendations, which rendered its power quite limited. In fact, the only time the Council decided to issue a country-specific recommendation for violating the BEPGs this was completely ignored by the recipient country (Ireland).

Finally, the third worrisome aspect was the growing interconnections between EMU sovereign debts and the EMU banking system. During the 2000s, the launch of the euro together with the ECB policy to accept all EMU sovereign debt as collateral in its liquidity operations with banks (that is, operations to provide new financing to banks) led to a growing exposure of EMU banks to other Eurozone countries' sovereign debts. The result was a sharp increase of the share of sovereign debt held by non-nationals, particularly in the small countries. In the end of 2008, for instance, non-national holders represented 70 percent of total sovereign bondholders in Greece, 72 percent in Ireland and 86 percent in Portugal[19]. While this implied a high risk of contagion in case of an EMU country's debt default, such cross-national links were very much ignored before the start of the crisis, due to the fact that banking supervision in the EMU remained at the hands of national bodies which, by construction, "lack the whole picture of the industry"[20].

19. Buiter, Willem *et al*., "The Debt of Nations", *Citi Economics, Global Economics View*, January 2011.
20. Padoa-Schioppa, Tommaso, *The Euro and Its Central Bank: Getting United After the Union*, Cambridge: The MIT Press, 2004, p. 114.

3. The exercise of solidarity during the crisis

As seen in the previous section, during the first ten years of existence there was practically no exercise of inter-state solidarity within the EMU countries. Since 2010, however, the Eurozone crisis has forced member states to make some steps in the exercise of inter-state solidarity that were unimaginable just some years ago. But how solidaristic have been EMU countries since the start of the crisis? What is the nature of the solidarity exercised? Has this solidarity been coupled with an adequate dose of responsibility? And what, if any, has been the relation between solidarity and coordination during this crisis?

3.1. Enlightened self-interest not evident at first glance

Concerning the type of solidarity exercised, all over the crisis decisions on bail-outs and solidarity arrangements have been driven by enlightened self-interest considerations. Solidarity efforts have been prompted by the

double awareness that a) if left alone, an EMU country in financial difficulties might well end up making default, and b) a debt default of an EMU country will have catastrophic consequences for their own economies. However, these two facts were not evident for EMU politicians at the start of the crisis. Various factors explain this. In 2009, when the Greek government experiences the first financial difficulties, the possibility that a Western European country make default is seen as remote by most analysts and observers given the historical record (no sovereign defaults in Europe since 1948). Besides, EMU politicians are largely unaware of the strong interdependencies between the EMU economies. There is for instance few disclosed information on the level of exposure of EMU banks to the distressed Eurozone countries' sovereign debts, and even less on the EMU banks' exposure to the private debt of other countries. Finally, EU leaders are totally unaware of the potential contagion effects that might trigger the presence of sovereign default risks in one EMU country. During 2009 and early 2010, decisions on whether or not helping Greece are taken by balancing the (high) political cost of breaking the "no bail-out" rule against the benefits of avoiding the hardly improbable default of a small EMU country representing only 3 percent of the EMU economy. It is only later, when the lack of response to Greece sparks a major sell-off of other EMU government bonds, that the "Greek problem" starts to be seen as an "EMU problem" potentially affecting five EMU economies which, together, sum up almost 40 percent of Eurozone public debt.

3.2. Too much influence of national politics

The exercise of solidarity during the crisis has been hampered by the EU leaders' difficulties to identify their interest in helping the others, but also by the fact that there were no solidarity mechanisms at place, ready to be activated to provide financial support to an EMU country in need. This has forced EU leaders to combine the management of the crisis (i.e. giving help

to the countries in need) with the creation of new solidarity arrangements (first the EFSF and later on the ESM) to help other EMU countries eventually in need.

Created in a hurry, these new solidarity arrangements are forcefully of intergovernmental nature. In consequence, their activation is submitted to the veto power of all EMU member states, which implies that its intervention can continuously be called into question by national political concerns. This is actually what has happened in various occasions, when political elections in one or another EU country have menaced to block the decisions on "bail-outs" and solidarity arrangements[21]. This has been particularly the case in countries in which a minor, populist-type political party has found itself in a position to influence the governmental action, either because forming part of the coalition government (i.e, the FDP in Germany) or having a significant parliamentary representation (i.e. the True Finns in Finland).

3.3. False ideas on the costs of solidarity

Another aspect which has rendered the exercise of solidarity difficult has been the existence of false ideas on the costs of solidarity. In many EMU countries, the aid to the EMU countries-in-need has been falsely portrayed by certain media or political parties as a real transfer of money. For instance in Germany, at the moment of approving the first Greek package, the

21. For instance, the German chancellor Angela Merkel resisted to give her support to the first financial assistance programme to Greece because there was a regional election on 9 May 2010 in North Rhine-Westphalia and she did not dare to make a step that would be highly unpopular by German public opinion. One year later, the entrance of the True Finns into the Finnish parliament threatened to block the aid plan to Portugal.

newspaper *Bild* accused the government of giving billions to the Greeks while cutting spending on German schools and parks[22].

In this respect, it is important to clarify that the financial assistance conceded to the in-need member states has not consisted into the concession of grants but of non-concessional loans. To be precise, a distinction should be made between the first Greek bail-out provided in May 2010 and the Irish, Portuguese and second Greek "bail-outs", provided under the EFSF/EFSM/IMF scheme (European Financial Stability Facility/ European Financial Stabilisation Mechanism/International Monetery Fund). In the first case, the EU financial assistance has consisted into direct bilateral loans between each EMU country and Greece for an amount proportional to each EMU country's ECB capital share[23]. In the second case, it is the EFSF, the EFSM and the IMF who have provided non-concessional loans to the bail-out countries. To lend to these countries, the EFSF has borrowed money on the financial markets, backed by guarantees provided by the EMU countries. As with the loans to Greece, these guarantees are in proportion to each EMU country's ECB capital share. At present, the EMU countries have committed to provide guarantees to a maximum of €780 billion (which gives to the EFSF a maximum lending capacity of €440 billion)[24].

22. At the end of April 2010, the newspaper *Bild* commented "Supposedly we have no money for tax cuts, no money for school upgrades, no money to maintain parks, no money to fix our streets… but suddenly our politicians have billions of euros for the Greeks who have deceived Europe" (Manolopoulos, Jason, *Greece's 'Odious' Debt: The Looting of the Hellenic Republic by the Euro, the Political Elite and the Investment Community*, London: Anthem Press, 2011 p. 229).
23. Slovakia does not participate into this first financial assistance programme to Greece.
24. In order for the EFSF to be AAA-rated by credit rating agencies, each EFSF loan has to be covered by guarantees from AAA-rated sovereigns. As a consequence, the effective lending capacity of the EFSF is lower than the total amount of guarantee commitments from the EMU countries.

Table 2 – Bilateral loans provided by EMU countries to the first aid plan to Greece and maximum guarantee commitments to the EFSF (in billions of €)

	Bilateral loans provided to Greece (May 2010)	EFSF maximum guarantee commitments (initial guarantees)	New EFSF maximum guarantee commitments (since the implementation of the reform increasing the EFSF lending capacity to €440 billion)
Austria	2.30	12.24	21.64
Belgium	2.90	15.29	27.03
Cyprus	0.16	0.86	1.53
Estonia	0.00	0.00	2.00
Finland	1.50	7.91	13.97
France	16.80	89.66	158.49
Germany	22.30	119.39	211.05
Greece	0.00	12.39	21.90
Ireland	1.30	7.00	12.38
Italy	14.70	78.78	139.27
Luxemburg	0.21	1.10	1.95
Malta	0.07	0.40	0.70
Netherlands	4.70	25.14	44.45
Portugal	2.10	11.04	19.51
Slovakia	0.39	4.37	7.73
Slovenia	0.36	2.07	3.66
Spain	9.80	52.35	92.54
Total	79.59	439.99	779.80

Sources: www.efsf.europa.eu and European Commission, Directorate General for Economic and Financial Affairs, "The Economic adjustment programme for Greece – First review summer 2010", *Occasional papers 68*, August 2010.

Table 2 shows the bilateral loans provided to Greece and the maximum guarantees commitments provided by EMU countries to the EFSF. One can see that, for instance, Germany has provided a loan of €22.3 billion to Greece and has committed to a maximum guarantee to the EFSF of €211 billion. This latter is an important quantity: it is equivalent to almost

70 percent of the German 2012 federal budget[25]. However, one should be clear about what this data means. Firstly, these €211 billion are only a maximum commitment: they do not represent the amount of the guarantees effectively made by Germany to the EFSF until now. EMU countries provide guarantees progressively, only up to the amounts needed by the EFSF to borrow money to the markets and make EFSF disbursements to the bail-out countries. By the end of 2011, the EFSF has borrowed €16 billion, of which Germany guaranteed approximately €7 billion[26]. Secondly, the guarantees will only be called in from the guarantors by the EFSF if one of its borrower countries defaults; this has not happened so far.

As said above, all these guarantees and loans have been falsely portrayed as a real transfer of money. Although there is an implicit act of solidarity in these initiatives, if the risk does not materialise (that is, if the bail-out countries reimburse their loans) the EMU countries will recover the money they have lent to Greece and the guarantees they have made to the EFSF will not be called in. In other words, as long as Greece, Portugal and Ireland honor their commitments, there will be no costs for EMU member states. As these loans are attached to a strict conditionality, one might argue that the risk of non-reimbursement is low. In the case of Greece, it is true that there has been a soft restructuring of its debt, but so far this has only concerned the debt owned by private investors, having then no consequences for public financing.

Another fear related to the loans to Greece and the guarantees accorded to the EFSF is that they deteriorate national public finances. This statement needs to be qualified. As stated in a Eurostat note from January 2011, EMU countries' guarantees provided to the EFSF are considered for the

25. The German federal budget for 2012 amounts to €306.2 billion.
26. The EFSF borrowed €16 billion to lend €12.5 to Ireland and Portugal. This amount borrowed by the EFSF is backed by member states with guarantees amounting to 165% of the quantity borrowed (that is, €26.4 billion), which are shared by EMU member states according to the ECB capital key.

calculus of gross government debt[27]. However, contrary to what many people believe, neither the Greek loans nor the guarantees accorded to the EFSF are counted on the public deficits (as long has no country receiving financial assistance defaults).

3.4. A wrong narrative of the crisis… having consequences in terms of conditionality

The way solidarity has been exercised during the crisis has been strongly influenced by the way EU leaders have interpreted the causes of the Eurozone debt crisis. All over the crisis, the dominant interpretation (promoted by Germany) has been that the EMU sovereign debt crisis is the result of the irresponsible behavior of certain governments which, relying on an implicit bail-out guarantee, cheated in the implementation of the SGP rules or which, during the years preceding the crisis, did not undertake the necessary unpopular reforms to improve the competitiveness of their economies.

This interpretation of the crisis as the result of the countries-in-need's faults and mistakes has had consequences in the way of applying conditionality. Interest rates attached to the bail-outs have been very high, the logic being to "punish" the countries that had committed errors and to avoid moral hazard[28]. These higher interest rates hampered the EMU "bailed out" governments' efforts to reduce the deficit and slow down the

27. As stated in a Eurostat note of January 2011: "The debt issued by the EFSF for each support operation for a member of the euro area must be reallocated to the public accounts of states providing guarantees, in proportion to their share of the guarantees for each debt issuing operation. The recording of these flows via the member states providing guarantees will have an impact on their gross government debt (as defined in the Maastricht Treaty), but this transaction will be neutral in terms of debt, net of the loans they have granted for support operations to other member states. (Eurostat, "The Statistical Recording of Operations Undertaken by the European Financial Stability Facility", 27 January 2011).
28. In this respect, a comparison of the conditions attached to the loans given to non-Eurozone countries in 2009 (in the context of the financial assistance programme for non-EMU member states foreseen in article 143 TFEU) and those attached to the loans to the EMU countries in 2010 and 2011 is illustrative. While the first had an interest rate of 3.5%, the loans to Greece, Ireland and Portugal were conceded at an interest rate higher than 5%.

path of debt accumulation. The July 2011 decisions to lower the interest rates of EFSF loans and to increase the co-financing rates of the EU funds in these countries under financial assistance seem to indicate that EU leaders have finally recognised the negative effects of a too strict conditionality and the need to be less severe and more helpful with the countries in need.

3.5. … and influencing the responses in terms of coordination

As seen in section 1, there is a clear and inverse relationship between solidarity and coordination: had we had stronger and more effective economic policy coordination before the crisis, the current debt problems would have probably been avoided. This causal link between coordination and solidarity has been widely recognised by the EU leaders, to the point that some of the EU countries which were sceptical on the benefits of coordination in the years prior to the crisis (Germany above all) are now the most vociferous in pleading for a strengthening of the EMU governance to prevent a new crisis to happen.

However, while accepting that coordination has failed, there has been a tendency to blame the countries-in-need for these failures. In short, the dominant interpretation is that the countries-in-need cheated in the application of the coordination mechanisms that were already in place. This interpretation of the facts fits well in the case of Greece (which effectively cheated in the application of the SGP) but not with the rest of Eurozone countries under market pressure. Besides, even if Greece and the rest of the EMU countries committed mistakes, there is also a collective responsibility on what has happened to these countries. True, the Greeks cheated in the application of the SGP pact, but this would have been detected had the Council accepted the Commission's 2005 proposal for a regulation designed to empower Eurostat to conduct on-site inspections of national

statistics[29]. True, some peripheral EMU countries experienced a gradual loss of competitiveness and a sharp increase in their external deficits but the danger of this was already known in the mid 2000 and yet, the Council did not issue country-specific recommendations asking these countries to address these problems. True, some countries (Ireland, Spain) experienced an unsustainable accumulation of private sector debt during the years preceding the crisis, but the latter would have been detected and addressed had we had a strong and unified EMU system of financial supervision.

This interpretation of the facts has influenced debates on the reform of the EMU economic governance. For Germany and other "strong" EMU countries, improving the coordination within the EMU basically means strengthening budgetary surveillance and punishing those countries which maintain large current account deficits over time. This vision has been very influential in the negotiations of the "six pack" legislative proposals[30]. Although Germany has not always succeed in imposing its "asymmetric" approach to coordination – i.e. despite German's opposition, the procedure to control external balances will apply both for countries on external deficits and in surpluses – the main goal of the reforms is to strengthen fiscal discipline and force EMU countries with external deficits to improve the competitiveness of their economies.

29. Padoa-Schioppa, Tommaso, "The Debt Crisis in the Euro Area: Interest and Passions", *Notre Europe Policy Brief*, No. 16, May 2010. As explained by Padoa-Schioppa in this article, in 2004 the European Commission noticed that the results on the basis of which Greece had been admitted into the euro area rested on falsified statistics: the Greek public deficit had been approximately 2 percentage points of GDP higher than the figures that Greece had sent Brussels for every single year between 1997 and 2003, and in every instance it was more than 3% of GDP. When this falsification of the statistics became public knowledge and the first "Greek affair" erupted, the Commission submitted a proposal for a regulation (March 2005) designed to empower Eurostat to conduct on-site inspections of national statistics. The Council rejected the proposal. The member states, including Germany, did not want to see Eurostat playing the policeman with their accounts because they felt that that would be detrimental to their national sovereignty.
30. The "six pack" refers to a package of six legislation acts which have been approved in November 2011. Three of them deal with the reform of the SGP, basically by extending and strengthening the use of sanctions. Two other regulations introduce a mechanism for the prevention and correction of excessive macroeconomic imbalances and a directive addresses the requirements for the national budgetary frameworks.

3.6. A failure to understand the systemic causes of the crisis

By treating the Eurozone's debt problem as a series of individual problems affecting different EMU countries, EU leaders have also failed to understand the systemic roots of this crisis. In effect, the debt problems experienced by various EMU countries during this crisis are partly related to some systemic features of the Eurozone which have the unintended effect of rendering EMU countries more fragile than others face to a global financial crisis. These systemic features are two.

The first is the fact that EMU countries issue debt in a currency over which they do not have full control[31]. This implies that a liquidity crisis in these countries – if strong enough – can force the government to make default. Investors know this fact and act in consequence: when an EMU country experiences budget difficulties, they over-react by raising the risk attached to the bonds of this country. This in turn increases the interest rates of the country's bonds, aggravating the problems of liquidity. The result is a "self fulfilling solvency crisis": the country becomes insolvent because investors fear insolvency.

The second systemic feature concerns the EU arrangements for banking supervision and crisis resolution. As noted by Véron[32], over the last decades EU banks have internationalised their activity. Today, the largest European banks have 57 percent of their activity outside of their home country, while the average ratio is only 22 percent among a comparable sample of the largest US banks. Despite this internationalisation, the competences on banking supervision and crisis resolution remain largely

31. De Grauwe, Paul, "The Governance of a Fragile Eurozone", *CEPS Working Document*, No. 346, May 2011.
32. Véron, Nicolas, "The European Debt and Financial Crisis: Origins, Options and Implications for the US and Global Economy", prepared statement before the U.S. Senate Committee on Banking, Housing and Urban Affairs: Subcommittee on Security and International Trade and Finance, September 2011.

national in the EU[33]. In particular, member states remain responsible to fiscally intervene with equity or capital-like instruments in a banking crisis situation and they are also responsible of guaranteeing bank deposits (even though these guarantees are harmonised by the EU legislation). As EMU banks are typically very large relative to their national economies, a domestic banking crisis can thus easily trigger a sovereign debt crisis[34]. Besides, given the facility of capital mobility within the Eurozone, they are particularly vulnerable to bank runs in the event of a banking crisis.

3.7. A lack of credible commitment to help

Finally, while EU leaders have effectively provided help to EMU countries in need through various acts and important decisions, they have also transmitted to the markets the message that they are not willing to do "whatever necessary" to avoid an EMU country make default and thus an Eurozone break-up. This has been one of the main reasons why market turbulences have not yet stopped.

The lack of a credible commitment to help has been reflected in two aspects. The first is a continuous reluctance to increase the size of the EU solidarity mechanisms (EFSF and ESM), despite the fact of knowing that the latter are insufficient to cover the needs of all EMU countries under severe market pressures. The second is the insistence in involving the private sector into the EU rescue packages.

This latest point is particularly relevant, as it illustrates EU leaders' difficulties to understand the magnitude of the problem to which they are

33. The EU competences on banking supervision have been reinforced with the creation of the European Banking Agency (EBA) in January 2010. However, the EBA has limited supervisory control, and still relies on information provided by national supervisions to do its tasks.
34. This is actually what happened to Ireland in November 2010, when the costs of bailing out some Irish banks raised the Irish public deficit to 32 percent of GDP, forcing the government to ask for financial help from the EU and the IMF.

confronted. In principle, the idea of involving the private sector into the EU rescue packages (and thus of asking EMU countries under assistance to restructure their debt) is fully justifiable. It basically responds to moral hazard considerations: forcing private investors to pay part of the bill and forcing EMU countries under assistance to restructure their debt is a way of preventing risky lending (from banks) and excessive borrowing (from countries) in the future. However, during the crisis, each decision to involve the private sector has translated into a loss of confidence of private investors on EMU sovereign debts, thus making the crisis more severe[35]. In the current circumstances, when the fate of the Eurozone is at stake, EU leaders have failed to understand that moral hazard considerations should take secondary seat and that the priority now should be preserving the Eurozone.

35. For instance, at the insistence of Germany, in October 2010 EMU member states agreed on the introduction of some provisions in the new ESM agreement to ensure the participation of the private sector in future bail-outs, the ultimate purpose being to "protect taxpayers' money". While this agreement is intended to restore markets' confidence, the announcement of the inclusion of these provisions has the opposite effect. Right after this inclusion was decided at the European Council meeting of October 2010, the interest rates of Greek, Irish, Portuguese and Spanish bonds sharply rose.

4. Looking forward: what type of solidarity within the EMU member states?

Having reviewed the 1990s debates on EMU governance as well as the practice of solidarity prior and during the crisis, it is time to put forward some proposals on the type and amount of solidarity needed in the EMU in the years ahead. To this purpose, it is useful to make distinction between short-term and long-term solidarity challenges.

In the short term, the priority is to stabilise EMU sovereign debt markets and stop the vicious circle of fiscal austerity and low growth in peripheral EMU countries. This requires an extraordinary effort of "enlightened self-interest" solidarity, with richer, triple-A EMU countries committing to help the most distressed ones. This solidarity should be exercised as long as needed to get out of the crisis and should combine measures to stabilise debt markets (a credible "deterrent") with action to help weaker EMU countries resume growth. The exercise of solidarity should be driven by the conviction that the costs of a euro break-up are unacceptably high (from an economic, political and social point of view). In coherence, con-

siderations on the countries' responsibility for the cause of neediness ("*ex ante*" responsibility) should be set aside. This does not mean that solidarity has to be unconditional: as in any exercise of solidarity, the provision of help should be coupled by an adequate dose of "*ex post*" responsibility from the countries receiving help, be in form of conditions attached to the use of the aid or the obligation of introducing certain structural reforms in their economies.

Once the things will calm down, we should put an end to this extraordinary exercise of non-reciprocal solidarity. The EMU is not intended to be a permanent "transfer" Union, in which richer members transfer resources to the poorer ones on a regular basis. To prevent this to happen, however, it is essential to avoid pronounced intra-EMU structural imbalances in the future. This requires improving and strengthening the procedures of economic policy coordination within EMU countries, but also re-visiting the conditionality and functioning of the EU cohesion and structural funds, which are officially intended to reduce EU-wide structural disparities. Apart from preventing pronounced intra-EMU imbalances, there is a need to provide adequate coverage for certain risks to which EMU countries are particularly vulnerable (the risk of suffering a self-fulfilling solvency crisis, the risks of bank runs and/or major banking crisis). Finally, the EMU should equip itself with a capacity to develop a concerted fiscal action in exceptional circumstances.

4.1. In the short term: a credible commitment to exercise "enlightened-self interest" solidarity as long as needed

In the very short term, EMU governments should convince the markets that they are ready to help other EMU countries in trouble as long as needed,

and that they have the capacity and means to do so[36]. This implies action in two fronts: a credible deterrent to stabilise sovereign debt markets (4.1.1) and actions to help EMU peripheral countries regain growth (4.1.2.).

4.1.1. A credible deterrent to stabilise EMU sovereign markets

The solidarity arrangements created to help EMU countries in trouble (the EFSF and the future ESM) are not credible in the eyes of the financial market community. Their current lending capacity is insufficient to cover the needs of all EMU countries under serious market pressure (particularly Italy and Spain). Besides, the lending capacity is dependent on the credit worthiness of those countries providing the bulk of the guarantees. Finally, both the EFSF and the ESM are intergovernmental instruments. In consequence, their activation is submitted to the veto power of all EMU member states, which implies that its intervention can continuously be called into question by national political concerns.

A credible deterrent to stabilise EMU sovereign debt markets should accomplish the double condition of a) having an important (ideally unlimited) lending capacity to cover all eventual EMU countries' liquidity needs and b) being capable of quickly deploy the aid required. At present, there are only two options that fulfill these conditions: one is a massive ECB intervention on sovereign debt markets, the other is to issue debt with the joint and several guarantees of all EMU member states – that is, Eurobonds. In the following, we will discuss the solidarity implications of each of these two options.

a. Giving the ECB a role of "lender of last resort"?

The first option is that the ECB commits itself to purchase Eurozone sovereign debt as long as needed to stabilise the markets. At present, the

36. Bertoncini, Yves, "The dilemma between austerity and stagnation" *in* "European Steering Committee of *Notre Europe*: Key Elements", *Synthesis*, December 2011.

ECB is already buying sovereign bonds from the secondary markets, via its Securities Markets Program (SMP). However, the amount of sovereign debt hold by the ECB is rather low and the ECB board has made clear its refusal to significantly enhance this programme.

To become a credible backstop, the ECB should make an explicit and unlimited commitment to purchase Eurozone sovereign debt. There are major legal obstacles to that. To start with, art. 123.1 of the Treaty explicitly forbids the ECB from granting credit facilities and from directly buying government bonds[37]. As the article only prohibits the direct purchase of sovereign bonds (i.e. at the primary market), a literal interpretation of the text would suggest that the ECB can still purchase sovereign bonds through the secondary market (as indeed the ECB is currently doing through its SMP). However, one might argue that the real purpose of this article is to forbid any form of monetary financing of fiscal deficits. In this respect, an ECB explicit commitment to purchase sovereign debt – clearly intended to avoid a default – would be contrary to the Treaty[38]. Another legal obstacle concerns the ECB independence. Art. 130 TFEU explicitly forbids the ECB council from "seek[ing] or tak[ing] instructions from Union institutions, bodies, offices or agencies, from any government of a member state or from any other body". In practice, this means that any decision to engage in this function of "lender-of-last-resort" would have to be taken (at least formally) by the ECB governing council itself, something which seems very difficult given Art. 123.1 *(see above)*. Alternatively, the political bodies could modify the ECB statute, but this would imply a change of the Treaty. Finally, some people argue that a massive purchase of sovereign bonds would be contrary to the ECB's legal mandate, whose first mission is to

37. "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the member states (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of member states shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments." (Art. 123.1 TFEU)
38. This is why the ECB is very keen at emphasising that the aim of the SMP is not to help sovereigns in trouble but to "restore a better transmission of monetary policy decisions".

guarantee the price stability in the Eurozone. This objection however is rather weak: as pointed out by most economists, inflationary risks are very low in the current recessionary context[39].

From a solidarity perspective, a first aspect to note is that a massive ECB purchase of sovereign bonds will probably undermine the future ECB's credibility in fighting inflation. As highlighted by many observers, this should be seen as secondary concern in the current circumstances. However, that reminds us that the ECB option is not the cost-free solution some want to believe. Besides, there is an implicit solidarity in the fact of allowing the ECB to play this role. Some countries will particularly benefit from this (those countries in trouble) but all Eurozone countries would assume its long-term costs (the loss of the ECB's credibility).

Secondly, it is widely argued that if the ECB commitment to act as a "lender of last resort" is credible, the simple fact of announcing it would stabilise the sovereign debt markets. Financial markets would anticipate the ECB intervention, and this would stop self-fulfilling movements of distrust vis-à-vis the EMU sovereign debts. If this is the case, the ECB will not have to engage into a massive purchase of sovereign bonds and it will not increase its exposure to potential losses. However, if for any reason the ECB commitment is not credible, or the ECB intervention is not as successful as expected (that is, if despite massive ECB purchases some governments fail to service their debt), then the ECB will incur into losses. From a solidaristic point of view, it is important to highlight that these losses will not be equally distributed among EMU countries. As all profits and losses from ECB operations, they will be distributed among Eurozone's national central banks (and thus among EMU member states) according to

39. Concerning the ECB mandate, it should be also noted that price stability is the ECB's primary objective but not the only one. Among the "basis tasks" assigned to the ESCB (and therefore to the ECB) are to "contribute to the smooth conduct of policies pursued by the competent authorities relating to… the stability of the financial system" (Art. 127.2 and 127.5 TFEU). Thus, one might argue that, in the absence of clear short-term inflationary risks, an ECB intervention of this type could be legitimated on the ECB's competence on financial stability.

their respective ECB capital share. Thus, Germany (with a share capital of around 27 percent) would bear a higher percentage of ECB losses than Italy or Spain (whose central banks hold 17.8 and 11.8 percent of ECB shares respectively).

Finally, as in any solidaristic action, an ECB intervention should be complemented with an adequate dose of responsibility. Otherwise, there is a risk that national governments benefiting from the ECB purchases stop adopting unpopular austerity measures if they know the ECB would back them. In principle, this could be solved by conditioning ECB purchases of sovereign bonds to the implementation of a fiscal adjustment or structural reform program. However, being a politically independent body, the ECB has no legitimacy to impose political reforms to national governments. A way of getting round this impediment is by establishing an intermediate political body between the ECB and national governments. The proposal of endowing the EFSF with a banking license and re-financing it through the ECB could be one solution in this respect. In this scenario, the ECB would provide financing to the EFSF, and it would be this latter one the responsible of making purchases of national sovereign bonds. Being a politically controlled body, the intervention of the EFSF could be then conditioned to a national programme of austerity and structural reforms.

b. Eurobonds as a (temporary) crisis resolution mechanism

The second option is to issue debt backed with the guarantee of all Eurozone's member states. This implies making all EMU countries jointly liable for the debt issued by each of them.

The common issuance of debt implies a transfer of risk, with "strong" EMU countries assuming part of the risk of default of "weak" EMU countries. However, the degree of solidarity exercised depends on the nature of the guarantee attached to the Eurobonds. The politically easiest solution would be to create a system in which each EMU country is liable for its

share of liabilities under a common Eurobond, according to a specific contribution key (for instance the ECB capital key). However, such type of Eurobonds would not be a completely safe instrument for investors. To be a credible backstop, Eurobonds should imply joint and several guarantees; that is, each EMU country should be responsible not only for its own share of the Eurobond issuance but also for the share of any other country failing to honour its obligations. This is in fact a pre-requisite to make Eurobonds as safe as the best-rated EMU sovereign bonds.

The pooling of credit risk is a proof of solidarity but it is not the only one. The common issuance would also imply common interest rates, and thus equal costs to service the debt. In this respect, Eurobonds would allow weak EMU countries to refinance their debts at a lower cost and vice versa, they could entail higher borrowing costs for stronger EMU countries (in the hypothesis that the Eurobonds are not rated as high as their own bonds). As with the first element of solidarity (the transfer of risks) different designs for Eurobonds can imply different levels of solidarity in the way of sharing the costs of servicing the common debt. The acceptability of Eurobonds might then be further assured in a design in which EMU countries participating in the common issuance pay different fees according to the creditworthiness of their public finances. Indeed, in the hypothesis that the Eurobond is rated as high as the debt of the best-rated EMU country, one can even imagine a system in which both countries with low credit rating and with high credit rating benefit from lower funding costs relative to national issuance.

As any solidarity act, the issuance of Eurobonds needs to have as a counterpart an element of responsibility from the countries benefiting from this solidarity. There is however a peculiarity in the way this responsibility is assured. In current EFSF bail-outs or in an eventual ECB action, assuring the responsibility basically means imposing some conditions to the countries receiving assistance. In the case of the Eurobonds, however, it is more difficult to single out the countries benefiting from the aid:

potentially, all except the best-rated EMU countries would benefit from it. In addition to that, responsibility is not only needed to avoid the default of highly-indebted countries but also to reduce moral hazard in all EMU governments (including those having a triple A) as it is necessary to avoid the downgrade of their debts to safeguard the high credit quality of the Eurobonds. The corollary of this is that Eurobonds ask for an increased responsibility from all EMU member states. A reinforced fiscal surveillance and economic policy coordination in the EMU is thus an essential counterpart of a common debt mechanism and it is hence not surprising that people make a logical link between the debate on Eurobonds and debates on the reform of the EMU governance[40].

As a crisis resolution mechanism, the Eurobonds would have an important disadvantage with respect to an ECB action, and this is that they cannot be created overnight. Several months would be needed to agree on the technical aspects and the creation of common bonds under joint and several guarantees would require a reform of the EU Treaty in order to change the no bail-out clause (which prohibits member states from assuming liabilities of another member state). However, many people believe that a prior political agreement on common issuance would confirm member states' willingness to avoid at any cost a break-up of the EMU and would in consequence have an impact on market expectations. For this engagement to be credible, it should be accompanied by the adoption of a clear road-map with the several steps foreseen to get to the Eurobonds.

Finally, it is important to highlight that, so far, we have conceived Eurobonds as a crisis resolution instrument whose principal aim is to stop the EMU sovereign market turmoil. As a crisis instrument, Eurobonds are an expression of enlightened self-interest solidarity. In effect, a common issuance of

40. In addition to a robust framework for budgetary discipline, foreseeing a redistribution of funding advantages scheme as well as limiting the Eurobonds to part of the national debt would contribute to reduce the risk of moral hazard.

debt in current market conditions implies a transfer of risks between strong EMU countries, largely spared from the market turmoil, and weak EMU countries which are currently at the eye of the storm. As a crisis resolution system, Eurobonds would be most logically a temporary device[41]. However, one might wonder whether Eurobonds could still be useful after the crisis, when member states would (hopefully) have consolidated their public finances and, as a consequence, the bond spreads would have tightened. In such a context, Eurobonds would be conceived as a permanent device and would have a different nature, as we will explain in section 4.2.2.

4.1.2. Stimulating growth in the EMU periphery

Measures to deter the turmoil in EMU sovereign markets will not be sufficient if not accompanied with actions to stimulate growth in the Eurozone periphery[42]. Indeed, no matter how courageous and disciplinant they are in applying austerity, the EMU countries in trouble will not be able to stabilise their debt-to-GDP ratios unless their economies resume growth, and the latter is practically impossible without external help.

The idea that EMU countries in trouble need external help to regain growth has not yet been fully recognised at the EU level. It is true that the Commission has approved some measures that go in this direction (concretely, the decision to anticipate and allow for a more flexible use of the structural funds earmarked for these countries) but the dominant thinking in various EMU countries – particularly in Germany – is that these countries need to pass structural reforms in their labour and product markets to become again competitive, and that only by passing these reforms can these countries regain growth. This way of thinking ignores the short-term growth needs of these countries. In effect, while nobody doubts that periph-

41. See for example the proposal of the German Council of Economic Experts on a redemption fund: Bofinger, Peter *et al.*, *A European redemption pact*, November 2011, VoxEU.org.
42. Declaration of the European Steering Committee of *Notre Europe*, "Austerity, but also growth", *Tribune*, 19 November 2011.

eral EMU economies have competitiveness problems, supply-side structural reforms will only lift growth in the long term. In the short term, EMU peripheral countries need some external help to break the vicious circle of low growth, budgetary austerity and high deficits in which they are trapped.

"Strong" EMU countries should acknowledge this and act in consequence. They should provide some help to peripheral EMU countries to counteract the recessionary impact of the fiscal adjustment these countries are forced to apply. This could materialise into the creation of a specific temporary investment fund for these countries, aimed at financing growth-enhancing investment projects having a significant short-term economic impact[43]. Another possibility would be to extend the temporary reduction of co-financing rates of the EU cohesion policy to other EMU countries under market pressure (i.e. Italy and Spain) or to extend it over time, i.e. maintaining this reduction during the first half of the next programming period (that is, from 2014 to 2017)[44]. Finally, another way through which "strong" EMU countries could help "weak" EMU countries regain growth is by committing themselves to stimulate their own domestic demand through the adoption of expansionary fiscal policies[45]. This would benefit weaker EMU countries, as it would create a demand for their imports. As national reforms to rebalance the economy would probably be politically costly for the governments of "strong" EMU countries (they will create some losers in the short-term), to a certain extent, a measure of this type would also imply an exercise of solidarity between "strong" and "weak" EMU countries.

43. Marzinotto, Benedicta, "A European fund for economic revival in crisis countries", *Bruegel Policy Contribution*, February 2011.
44. Notice that, as long as these measures are financed through the current EU budget, they would imply an exercise of solidarity within all EU member states and not only within strong and weak EMU countries.
45. Tilford, Simon and White, Phillip, "Why stricter rules threaten the Eurozone", *Centre for European Reform*, November 2011.

4.2. In the long term: rendering the EMU more resilient to crisis

In the long term, the priority is to prevent the repetition of crises like the current one as well as to equip the EMU to manage them if they were to happen again. An important pre-condition to avoid future crisis is to reduce pronounced intra-EMU imbalances through better coordination and through better use of the EU cohesion and structural funding (4.2.1). Apart from that, the EMU would be better equipped to manage new crisis if endowed with two EMU-wide insurance systems, one protecting countries from the risk of liquidity crisis (4.2.2) and the other covering bank deposits (4.2.3), as well as with the capacity to develop a concerted discretionary fiscal action in the event of a major global or EMU-wide crisis (4.2.4).

4.2.1. Better use of EU cohesion and structural funds

Reducing large EMU imbalances is essential to avoid new crisis. To this purpose, it is important to reflect on how to induce the necessary structural reforms in both countries having large external surplus and large external deficits.

Further deepening of the single market and an effective use of the recently approved procedure to correct and control macro-economic imbalances can be of help. These two measures, however, will not be enough to induce the necessary reforms in EMU peripheral countries. To reduce their external deficits, these countries have to boost their competitiveness through structural reforms in various areas (labor and product markets, taxing systems, education and research). However, being those countries most hit by the crisis, the governments of those EMU countries are unable to make some of the necessary investment efforts (i.e. in human capital or research). They are also unable to finance complementary measures which might deem important to facilitate the passage of unpopular structural reforms (such

as worker re-training programmes, support to new entrepreneurs or aid to new infant industries).

The procedure to control macro-economic imbalances, with its exclusive reliance on recommendations and sanctions ("sticks"), should be complemented by an intelligent and effective use of EU cohesion and structural funding in these countries ("carrots"). As it is well-known, too often in the past the EU funding pre-allocated to these countries has been either under-spent (due to problems of financial absorption) or inefficiently spent (as a result of weak planning and delivery structures). In the coming 2014-2020 programming period, it is essential to resolve the problems of financial absorption and to strengthen the conditionality attached to the use of aid[46]. In addition to that, there is a case for reinforcing the powers of the European Commission in the planning and in the selection of projects, at least for those countries pertaining to the Eurozone. As these countries' economic fate is a matter of serious concern for the rest of EMU members, more EU control on how these countries spent the EU cohesion money is justifiable. A greater involvement of the European Commission in the planning stage would ensure that EU cohesion funding is primarily used to address these countries' major structural weaknesses and to facilitate the passage of necessary structural reforms in the years ahead.

4.2.2. Eurobonds as a (permanent) insurance mechanism

The EMU needs to equip itself with an insurance-type mechanism geared to assist any EMU country suffering an acute liquidity crisis. This is essential to shield EMU countries from the risk of suffering a "self-fulfilling solvency crisis".

One might argue that there is already a mechanism of this type: the ESM, which is expected to replace the EFSF in mid-2012. However, the ESM

46. Marzinotto, Benedicta, *op. cit.*

presents three major shortcomings. First, like the EFSF, it is an intergovernmental mechanism. Its interventions will have to be approved by EMU member states and ratified by their national parliaments, something which render decisions on whether or not helping a country dependent on national political circumstances (and thus uncertain)[47]. Second, with its 500 € billion of lending capacity, the ESM can only cover about 6% of EMU's public debt. This amount is clearly insufficient to allow the ESM to be a credible firewall against self-fulfilling liquidity crisis if no other mechanisms are foreseen (for instance ECB's interventions in the primary or secondary debt markets). Finally, as the EFSF, the ESM is conceived as a last-resort instrument which is activated only when a country is in serious trouble. As it has been observed with the EFSF during the crisis, this "last resort" approach has an important drawback: it helps private investors identify those countries which are in most serious trouble. As a result of this, the fact of receiving EFSF/ESM assistance can sometimes aggravate the situation of a country rather than redress it. That is why most EMU countries currently under EFSF assistance have resisted until the very end being bailed out by the EFSF.

In order to be credible and effective, an EMU liquidity mechanism should: a) be able to be quickly activated on pre-agreed conditions (for instance once bond spreads surpass a certain level), b) cover a significant part of EMU countries' short-term liquidity needs and c) shield all EMU countries from the risk of "self-fulfilling solvency crisis" while avoiding the unintended effects of a "last resort" mechanism.

Providing all EMU member states consolidate their public finances in the medium term and reduce their debt-to-GDP ratios to less than 60 percent, Eurobonds appear as the ideal EMU institutional arrangement to cover

47. To resolve in part this problem, the December 2011 European Council agreed to include an emergency procedure in the ESM voting rules. This emergency procedure will allow member states to take a decision by a qualified majority of 85% in some exceptional cases. Even if this decision goes in the right direction, it is still insufficient to convert the ESM into a credible and effective mechanism to address liquidity crisis.

the risk of liquidity crisis. In effect, in a scenario in which national debts are below 60 percent and all EMU countries conduct responsible fiscal policies, Eurobonds would not work as a mechanism of non-reciprocal solidarity (implying a transfer of risk from "weak" to "strong" EMU countries), but rather as an insurance arrangement covering all EMU countries from a common risk. As an insurance arrangement, they would fulfill the three preconditions listed above.

The major obstacle to use Eurobonds as an insurance mechanism is that it is submitted to various important "ifs" – that is, it is only feasible if all EMU states reduce their debt-to-GDP ratios to significantly lower levels and if their commit in a credible way to conduct responsible fiscal policies in the future. One might wonder whether the various reforms which have been passed and/or which are currently at debate to strengthen fiscal discipline within the EMU will suffice to get the Eurozone into this hypothetical scenario in a medium-term horizon.

It is not here the place to discuss the relative merit of current reforms. However, an aspect that is sometimes forgotten in current debates is that Eurobonds can themselves constitute an incentive for fiscal discipline. In effect, it is frequently argued that a system of common issuance of bonds would eliminate the disciplinary effect of financial markets, thus weakening the incentives for fiscal discipline. While this "market" effect is true, it can be offset in a system of Eurobonds in which each EMU member pays a different fee according to the respective creditworthiness. One could even imagine a system in which an EMU country infringing the fiscal rules or not following the Commission's recommendations on fiscal discipline would have to pay an additional "penalty" fee to refinance their debt through common bonds. A partial financing of national public debt through Eurobonds (i.e. the famous blue bond/red bond proposal by Delpla and

von Weizsäcker[48]) would be also a way to secure that Eurobonds do not disincentive fiscal discipline. As member states would have lower interest rates for their "blue" bonds and higher ones for their "red" bonds, they would be induced to reduce their debt levels under 60 percent of GDP.

Finally, it is important to note that, besides this insurance effect, the establishment of Eurobonds on a permanent basis could report other additional advantages. It could offer the possibility of a large and highly liquid government bond market (comparable in size to the US treasury market), which would probably translate into lower costs of servicing Eurozone's public debts. Besides, a large government bond market would attract outside investors, strengthening the position of the euro as an international reserve currency.

4.2.3. An EMU-wide insurance fund for bank deposits

One of the things that have been put into evidence in this crisis is the existence of a strong link between sovereign debt and domestic banks. This link tends to become very dangerous in times of crisis, as the problems of sovereigns and banks mutually feed each other. On the one hand, as EMU banks hold large amount of "home" sovereign debt, a downgrade of the sovereign debt increases the fragility of the domestic banking system. On the other hand, a fragile domestic banking system increases the doubts on the solvency of its sovereign. This is because EMU banks are very big relative to their "home" economies and national governments are the sole responsible to fiscally intervene in the event of a banking crisis (by injecting capital to the bank or reimbursing the deposits holders).

To render the EMU more resilient to future crisis, it is important to avoid this dangerous feedback loop between sovereign debt and domestic

48. Delpla, Jacques and von Weizsäcker, Jakob, "The Blue Bond Proposal", *Bruegel Policy Brief*, No. 3, May 2010.

banking crisis. A way to do so is by pooling and sharing the risks derived from the banking system. One option would be to endow the EU level with competences on banking crisis resolution – by for instance creating a European version of the US Troubled Asset Relief Program (TARP)[49]. It is however difficult to bring this function at the EU level: deciding what to do with a bank in trouble implies a high level of political discretion and there might be cross-national differences in the ways of addressing these types of problems. A more feasible option is to replace national bank deposit guarantee schemes for an EMU-wide scheme. As pointed out by Véron[50], this would be more feasible and less controversial as public guarantees on bank deposit across the EU are partially harmonised and less discretionary. An EMU-wide guarantee on bank deposits would also have the additional advantage of preventing bank runs in the event of national sovereign debt crisis.

An EMU-wide insurance system could take different forms: it could be a publicly funded system but it could also take the form of a privately-financed insurance scheme funded through an insurance premium paid by all EMU banks accepting deposits[51]. In this second case the exercise of solidarity would be mostly across EMU banks. However, to be reliable, the system would ultimately be backed by a public guarantee (a joint guarantee from all EMU governments): hence, there will still be a degree of inter-state solidarity behind.

4.2.4. Giving to the EMU the capacity to develop a concerted fiscal action in exceptional circumstances

Finally, the EMU should have the capacity to develop a concerted fiscal

49. Klau, Thomas and Godement, François, "Beyond Maastricht: A new deal for the Eurozone", *European Council on Foreign Affairs Policy Brief*, No. 26, December 2010.
50. Véron, Nicolas, *op. cit.*
51. Marzinotto, Benedicta, Sapir, André and Wolf, Guntram B., "What Kind of Fiscal Union?", *Bruegel Policy Brief*, No. 6, November 2011.

action in the event of a large EMU-wide economic shock. At present, there is no procedure to define and conduct an EMU-wide fiscal policy strategy. EMU countries have full autonomy on fiscal matters as long as they comply with the upper deficit and debt limits. This is understandable: decisions on fiscal matters are of fundamental political nature and should respond to different national political preferences. However, as the recent crisis has shown, some exceptional situations might require a rapid and coordinated EMU-wide fiscal policy response. A long and painful process of political negotiation among the 17 national fiscal authorities can make such common policy response unfeasible, as proven by the European Commission's failed attempt to co-ordinate fiscal responses in 2008.

Finally, it is interesting to note that this idea of developing a capacity for EMU-wide concerted fiscal action brings us back to the Delors Report's proposal of coordinating fiscal policy decisions "to design an overall fiscal stance for the Community as a whole". The need for this Keynesian-type of fiscal policy coordination made consensus at the time of the Delors Report. This idea however was subsequently abandoned, partly because of greater scepticism about the effectiveness of fiscal policy in stabilising the economy but also because of the problems of democratic legitimacy that it raised. The current crisis has proven the important role fiscal policy can play to stabilise the economy, particularly when monetary policy is exercised at the maximum. Yet, the problems of democratic legitimacy are still present. This is why this type of coordination should be only used in exceptional times, as proposed by Bruegel in its report on the 10 years of the euro[52].

This capacity of concerted fiscal action has to be one of the components of the new "fiscal Treaty" which is currently being negotiated. The Treaty should include a clause allowing an EU body (the European Commission or

52. Pisani-Ferry, Jean *et al.*, "Coming of Age: Report on the Euro Area", *Bruegel blueprint*, No. 4, 2008.

the heads of state and government of the Eurozone acting under majority voting) to exercise extraordinary fiscal policy powers in the event of a major economic shock – that is, to define a common fiscal strategy and to formulate binding fiscal policy guidelines for EMU governments. These guidelines will have to be country-specific, as national governments will be called to do different fiscal efforts depending on their fiscal position of departure. In this respect, a concerted fiscal action always implies a certain degree of inter-state solidarity.

Final remarks

At the moment of writing this Policy Paper, the Eurozone sovereign debt markets have reached a point of relative calm. This has led some people to believe that the worst of the crisis might be over. While we would be the first to celebrate the end of the crisis, our analysis invites to be particularly prudent. Nobody knows what will happen in the coming months but one thing seems quite clear: the crisis will not be totally resolved until EU leaders fully acknowledge the magnitude and type of problems to which they are confronted and act in consequence. For this to happen, EMU politicians should recognise three "inconvenient truths".

The first is that there is no magic, cost-free solution to the Eurozone debt crisis. Neither a massive ECB intervention nor the private sector involvement into potential EMU debt restructuring is the easy, cost-free solution some want to believe. The first faces enormous legal and political obstacles and the attempts to apply the second have aggravated rather than resolved the crisis. More importantly, none of them are alternatives to EMU countries solidarity.

The second truth derives from the first. The only way to get out of the crisis is by accepting that, during a certain period of time, there is a need to make an extraordinary effort of "enlightened self-interest" (non-reciprocal) solidarity, with richer EMU countries helping the most distressed ones. This solidarity effort should be comprehensive, combining measures to stabilise debt markets (a credible "deterrent", such as the issuance of Eurobonds) with action to help weaker EMU countries resume growth. Equally important, it should be credible at the eyes of the financial markets: the latter should be convinced that EMU governments are ready to do whatever necessary to prevent a euro break-up and that they have the means to do so.

Finally, a third truth is that the EMU needs some permanent mechanisms of solidarity. As said above, the EMU is not intended to be a permanent "transfer Union", in which richer members transfer resources to the poorer ones on a regular basis. However, the EMU would be better equipped to prevent and manage future crisis if endowed with two EMU-wide insurance mechanisms; an insurance mechanism protecting EMU countries from the risk of liquidity crisis and an EMU-wide insurance fund covering bank deposits. Concerning the first (an EMU liquidity mechanism), we have argued in this Policy Paper that a well-designed system of Eurobonds could be an effective insurance arrangement covering all EMU countries from liquidity crisis, but that the latter is only possible under the hypothesis that all EMU countries significantly reduce their debt-to-GDP ratios in a medium term horizon and credibly commit to conduct responsible fiscal policies. Concerning the second (an EMU bank insurance), the best option seems to be an insurance mechanism funded through premiums paid by the EMU banks and backed by a joint public guarantee from all EMU governments.

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