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ΤΙΤΛΟΣ

Moving Beyond The Economics Of The Euro: A Theoretical Approach To EMU

ΟΝΟΜΑΤΕΠΩΝΥΜΟ

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**Διατριβή υποβληθείσα προς μερική εκπλήρωση
των απαραιτήτων προϋποθέσεων
για την απόκτηση του
Μεταπτυχιακού Διπλώματος Ειδίκευσης**

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Εγκρίνουμε τη διατριβή της [ονοματεπώνυμο]

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Abstract

This paper examines the framework governing EMU since the creation of the euro and the road towards today's EMU. In the beginning, the costs of a single currency are discussed in terms of losing the monetary policy independence and the government budgets. Furthermore, in order to show the differences between a country which is a member state of Eurozone and one which is not- as far as the government's control over the existing currency is concerned, I use two prototype scenarios for Spain and United Kingdom, respectively. It is briefly analyzed what happens when investors start having doubts about the solvency of these two types of country. The next section examines how the EMU actually works as well with the monetary policy in the Eurozone. What is more, concerning the benefits and the gains from being part of a single currency area, the advantages seem to outnumber the losses mentioned in the first lines and therefore, a big part of the following paper analyzes them individually in detail. In the last sections, the EMU is discussed from the framework of the recent Financial and Debt Crisis (2007-2010). The issue of the "wastefulness" of the Crisis arises and the impact of the latter on EMU is touched. To conclude, the below theoretical approach suggests that as EU Member States are still reluctant to transfer too many competences to EU level, the financial supervisory architecture could not be subject to any "revolutionary" change.

1. Introduction

The Economic Monetary Union and the creation of the euro is the most important institutional change in worldwide financial markets during the past quarter of the 20th century. The creation of an economic area with a single market and a single currency has been a unique endeavor in economic history. A single monetary policy over the euro-zone countries, due to the introduction of the euro has not been a failure, in contrast to the warnings of some critics. On the other side of the coin, the introduction of the common currency in the euro area countries has not launched a golden age of economic growth and flexibility, in contrast to some enthusiastic promises.

The economic and monetary policy in Europe faced quite unique challenges since the start of the EMU. Before the introduction of the single currency, a number of observers argued that the existence of independent national fiscal policies was unable to coexist with a supranational monetary policy, thus a single monetary policy was doomed to failure. Among others, Martin Feldstein (1997) predicted that the shift to the EMU and the political integration that would follow, it would be more likely to lead to increased conflicts within Europe and between Europe and the United States, instead of increasing intra-European harmony and global peace. Moreover, Martin Feldstein (2000) predicted that the euro is likely to have adverse medium-term and long-term effects on employment and inflation, and is likely to be the cause of political conflicts within Europe and between Europe and the United States. Nevertheless, the euro is firmly established as a stable currency that shares along with the US dollar the role of the key international currency, worldwide.

The introduction of the euro results in the reduction or even the elimination of some costs, because by moving from several national currencies to a common currency, some costs decline or even disappear. Inter alia, the advent of the single currency in the euro area contributes to the reduction of trading costs both directly and indirectly, by removing the exchange rate risk and the cost of currency hedging; it contributes, also, to the reduction of information costs.

Furthermore, the introduction of the euro is enhancing price transparency and discouraging price discrimination; hence, it reduces market segmentation and is fostering competition. The common currency is encouraging foreign direct investments and precluding the possibility of future devaluation of national currencies. Consequently, the euro is playing a catalyzing role.

The euro is expected to accommodate Europe proceeding on reforms in the labor and product markets. In order to improve the success of EMU, the need for these structural reforms is vital.

EMU is expected to remove some national procedures and rules along with other obstacles to both economic and financial integration; the so-called "borders". Additionally, a common currency is more efficient in performing its role as an accounting unit compared to multiple national currencies. Therefore, a single market along with a single currency supports convergence.

However, from another point of view, euro-zone countries, due to the introduction of the common currency, may become more specialized and less synchronized with the rest members, over the years. At the same time, some diversities and heterogeneities may surface or even deepen more over time, which may hinder the euro area integration.

Criticism of EMU in its first years had focused mainly on the comparably mediocre economic growth of the euro area overall while rarely commenting on the economic policy framework. During the crisis, in contrast, and especially with the onset of the sovereign debt crisis, the interest and concerns of observers moved beyond economics, to also touch upon the institutional and political capacity of the euro area's governance framework to deal with the crisis and its implications.

The Crisis period since 2007 put pressure on the operation of the institutional framework, motivating a different set of questions, such as "did it succeed in mediating and shaping national interests to the benefit of the common European interest?" or "will the crisis experience lead to a fundamental reform of EMU's structure and shift to a new development path?".

2. A history of failures

2.1. Fiscal problems at the roots of historical monetary unions' failures

Historical experience suggested that the creation of a monetary union without political union would be a highly risky undertaking. Two previous efforts at creating a monetary union of sovereign states in Europe both failed. In 1865, France, Belgium, Italy, Switzerland and Greece created the so-called Latin Currency Union. This union lasted until 1914, when financial pressures in some countries induced them to monetize government deficits. As a result of the de-basement of the currency, the union then broke apart. In 1872, several northern European countries created the Scandinavian Monetary Union. This project at least survived WWI. But in 1924 it also broke apart as some countries started to monetize their fiscal deficits. In both cases, the union unraveled when severe fiscal problems in part of the union led to a monetary funding of government deficits.

2.2. History of fixed exchange rate systems not encouraging either

The history of fixed exchange rate systems – a weaker form of a currency union – was also not encouraging. During WWI, the gold standard was suspended as countries used the money printing press to finance the war effort. Following the return to the gold standard after WWI, severe balance of payments imbalances emerged during the 1920s. France and the US both accumulated large gold reserves while the UK and Germany saw their reserves melt away. The problem was especially acute in Germany, which had to rely on short-term borrowing in the international capital market to fund its balance of payments deficit. When the short-term capital market seized up in the wake of the 1929 stock market crash, Germany experienced a financial crisis that led to a series of bank failures and deepened the Great Depression.

2.3. Break-up of the Bretton-Woods system

After WWII, the western powers replaced the pre-war gold standard with a fixed, but adjustable exchange rate system, the so-called Bretton-Woods system, where the US dollar performed the role of the monetary anchor. To avoid balance of payments crises that could bring down the system, an institution, the International Monetary Fund, was created and charged with monitoring economic performance, and in the case of balance of payments deficits, designing and funding adjustment programs. However, when in the late 1960s the US administration colluded with its central bank to provide monetary financing of fiscal deficits, an international excess supply of US dollars built up that led to the demise of the monetary anchor and in 1973 the break-up of the Bretton Woods System.

3. The Costs of a Common Currency

The costs of a monetary union derive from the fact that when a country relinquishes its national currency, it also relinquishes an instrument of economic policy, i.e. it loses the ability to conduct a national monetary policy. In other words, in a full monetary union the national central bank either ceases to exist or will have no real power. This implies that a nation joining a monetary union will no longer be able to change the price of its currency (by devaluations and revaluations), to determine the quantity of the national money in circulation, or to change the short-term interest rate.

One may raise the issue here of what good it does for a nation to be able to conduct an independent monetary policy (including changing the price of its currency). There are many situations in which these policies can be very useful for an individual nation. The exchange rate is useful as a policy instrument, for example, because nations are different in some important senses, requiring changes in the exchange rate to occur.

3.1. Monetary independence and government budgets

When countries join a monetary union they lose their monetary independence. As a result, that affects their capacity to deal with asymmetric shocks. This is the essence of the traditional theory of optimal currency areas as developed by Mundell (1961). This theory, however, is incomplete. It overlooks another major implication of the loss of monetary independence: the entry into a monetary union fundamentally changes the capacity of governments to finance their budget deficits. This is important, but surprisingly it was overlooked until the sovereign debt crisis in the Eurozone emerged in 2010.

Members of a monetary union issue debt in a currency over which they have no control. For example, when France, Germany, and Spain entered the Eurozone they ceased to issue their debt in their national currencies (the French franc, the German mark, and the Spanish peseta) over which they had full control. Instead, they now issue their debt in euros, a currency that none of these governments control. This has a profound implication. It implies that financial markets acquire the power to force default on these countries. This is not the case in countries that are not part of a monetary union, and that have kept control over the currency in which they issue debt. These countries cannot easily be forced into default by financial markets.
In order to show this is so, I analyze in detail what happens when investors start having doubts about the solvency of these two types of country. I will use the UK as a prototype monetary 'stand-alone' country and Spain as a prototype member country of a monetary union.

3.2. The UK scenario

Let's first trace what would happen if investors were to fear that the UK government might be defaulting on its debt. In that case, they would sell their UK government bonds, driving up the interest rate. After selling these bonds, these investors would have pounds that most probably they would want to get rid of by selling them in the foreign exchange market. The price of the pound would drop until somebody else was willing to buy these pounds. The effect of this mechanism is that the pounds would remain bottled up in the UK money market to be invested in UK assets. Put differently, the UK money stock would remain unchanged. Part of that stock of money would probably be re-invested in UK government securities. But even if that were not the case so that the UK government could not find the funds to roll over its debt at reasonable interest rates, it would certainly force the Bank of England to provide it with the cash to pay out bondholders. Thus, the UK government is ensured that the liquidity is around to fund its debt. This means that investors cannot precipitate a liquidity crisis in the UK that could force the UK government into default. There is a superior force of last resort, the Bank of England.

3.3. The Spanish scenario

Things are dramatically different for a member of a monetary union such as Spain. Suppose that investors fear a default by the Spanish government. As a consequence, they sell Spanish government bonds raising the interest rate. So far, we have the same effects as in the case of the UK. The rest is very different. The investors who have acquired euros are likely to decide to invest these euros elsewhere, say in German government bonds. As a result, the euros leave the Spanish banking system. There is no foreign exchange market and flexible exchange rate to stop this. Thus, the total amount of liquidity (money supply) in Spain shrinks. The Spanish government experiences a liquidity crisis, i.e. it cannot obtain funds to roll over its debt at reasonable interest rates. In addition, the Spanish government cannot force the Bank of Spain to provide the cash. The common central bank (the ECB in the Eurozone) can provide all the liquidity in the world, but the Spanish government does not control that institution. The liquidity crisis, if strong enough, can force the Spanish government into default because it cannot find the cash to pay out the bondholders. Financial markets know this and will test the Spanish government when budget deficits deteriorate. Thus, in a monetary union, financial markets acquire tremendous power and can force any member country onto its knees.

The situation of Spain is reminiscent of the situation of emerging economies that have to borrow in a foreign currency. These emerging economies face the same problem, i.e. they can be confronted with a 'sudden stop' when capital inflows suddenly stop, leading to a liquidity crisis (Calvo 1988 and Eichengreen et al. 2005).

4. European Monetary System and Euro

The European Monetary System (EMS) was constructed right after the collapse of the Bretton-Woods System, which was a fixed exchange rate system. The EMS was then the first step of an effort for monetary coordination and exchange rate stabilization between the nine countries which that time formed the European Economic Community (later, *European Community*).

This system evolved into a single currency, i.e. euro, which is being shared today by 18 out of 27 countries of the European Union.

4.1. The road to EMU

Economic and monetary union was a recurring ambition for the European Union from the late 1960s onwards because it promised stability and an environment for higher growth and employment.

However, a variety of political and economic obstacles barred the way. Weak political commitment, divisions over economic priorities and turbulence in international markets all played their role in frustrating progress towards EMU.

Despite these obstacles, the second half of the 20th century saw a constant search by the growing number of EU Member States for deeper economic integration as a means of strengthening the political bonds between them and protecting the common market.

The road towards today's Economic and Monetary Union and the euro area can be divided into four phases:

Phase 1: From the Treaty of Rome to the Werner Report, 1957 to 1970

The international currency stability that reigned in the immediate post-war period did not last. Turmoil on international currency markets between 1968 and 1969 threatened the common price system of the common agricultural policy, a main pillar of what was then the European Economic Community. In response to this troubling background, Europe's leaders set up a high-level group led by Pierre Werner, the Luxembourg Prime Minister at the time, to report on how EMU could be achieved by 1980.

Phase 2: From the Werner Report to the European Monetary System, 1970 to 1979

The Werner group set out a three-stage process to achieve EMU within ten years, including the possibility of a single currency. The Member States agreed in principle in 1971 and began the first stage – narrowing currency fluctuations. However, a fresh wave of currency instability on international markets squashed any hopes of tying the Community's currencies closer together. Subsequent attempts at achieving stable exchange rates were hit by oil crises and other shocks until, in 1979, the European Monetary System (EMS) was launched.

Phase 3: From the start of EMS to Maastricht, 1979 to 1991

The EMS was built on exchange rates defined with reference to a newly created ECU (European Currency Unit), a weighted average of EMS currencies. An exchange rate mechanism (ERM) was used to keep participating currencies within a narrow band. The EMS represented a new and unprecedented coordination of monetary policies between the Member States, and operated successfully for over a decade.

This success provided the impetus for further discussions between the Member States on achieving economic and monetary union. At the request of the European leaders, the European Commission President, Jacques Delors, and the central bank governors of the EU Member States produced the 'Delors Report' on how EMU could be achieved.

Phase 4: From Maastricht to the euro and the euro area, 1991 to 2002

The Delors Report proposed a three-stage preparatory period for economic and monetary union and the euro area, spanning the period 1990 to 1999. Preparations involved:

- Stage 1: completing the internal market (1990-1994), namely through the introduction of the free movement of capital;
- Stage 2: preparing for the European Central Bank (ECB) and the European System of Central Banks (ESCB), and achieving economic convergence (1994-1999); and
- Stage 3: fixing exchange rates and launching the euro (1999 onwards).

European leaders accepted the recommendations in the Delors Report. The new Treaty on European Union, which contained the provisions needed to implement EMU, was agreed at the European Council held at Maastricht, the Netherlands, in December 1991. This Council also agreed the 'Maastricht convergence criteria' that each Member State would have to meet to participate in the euro area.

After a decade of preparations, the euro was launched on 1 January 1999. At the same time, the euro area came into operation, and monetary policy passed to the European Central Bank (ECB), established a few months previously – 1 June 1998 – in preparation for the third stage of EMU. After three years of working with the euro as 'book money' alongside national currencies, euro coins and banknotes were launched on 1 January 2002 and the biggest cash changeover in history took place.

4.2. Economic and Monetary Union

Economic and Monetary Union (EMU) represents a major step in the integration of EU economies. It involves the coordination of economic and fiscal policies, a common monetary policy, and a common currency, the euro. Whilst all EU Member States take part in the economic union, some countries have taken integration further and adopted the euro. Together, these countries make up the euro area.

The decision to form an Economic and Monetary Union was taken by the European Council in the Dutch city of Maastricht in December 1991, and was later enshrined in the Treaty on European Union (the Maastricht Treaty). Economic and Monetary Union takes the EU one step further in its process of economic integration, which started in 1957 when it was founded. Economic integration brings the benefits of greater size, internal efficiency and robustness to the EU economy as a whole and to the economies of the individual Member States. This, in turn, offers opportunities for economic stability, higher growth and more employment – outcomes of direct benefit to EU citizens. In practical terms, EMU means:

- Coordination of economic policy-making between Member States

- Coordination of fiscal policies, notably through limits on government debt and deficit
- An independent monetary policy run by the European Central Bank (ECB)
- The single currency and the euro area

Economic governance under EMU

Within EMU there is no single institution responsible for economic policy. Instead, the responsibility is divided between Member States and the EU institutions. The main actors in EMU are:

- The European Council – sets the main policy orientations
- The Council of the EU (the 'Council') – coordinates EU economic policy-making and decides whether a Member State may adopt the euro
- The 'Eurogroup' – coordinates policies of common interest for the euro-area Member States
- The Member States – set their national budgets within agreed limits for deficit and debt, and determine their own structural policies involving labor, pensions and capital markets
- The European Commission – monitors performance and compliance
- The European Central Bank (ECB) – sets monetary policy, with price stability as the primary objective.
- The European Parliament - shares the job of formulating legislation with the Council, and subjects economic governance to democratic scrutiny in particular through the new Economic Dialogue.

What is meant by 'economic integration'?

Generally, economic and monetary union is an advanced step in the process of economic integration. The degrees of economic integration can be divided into six steps:

1. Preferential trading area (with reduced customs tariffs between certain countries)
2. Free trade area (with no internal tariffs on some or all goods between the participating countries)
3. Customs union (with the same external customs tariffs for third countries and a common trade policy)
4. Single market (with common product regulations and free movement of goods, capital, labor and services)
5. Economic and monetary union (a single market with a common currency and monetary policy)
6. Complete economic integration (all the above plus harmonized fiscal and other economic policies).

When the European Union was founded in 1958 as the European Economic Community, the aim was to build a customs union and a common market for agriculture. Subsequently, this limited common market was extended to cover also goods and services in the single market, which was largely completed by 1993. Today, the European Union is on the fifth step of this model. Progressive economic integration did not start with the decision to create the euro: it is a long process, part of the history of the EU, and one of its major achievements.

4.3. How Economic and Monetary Union works

Economic and Monetary Union is not an end in itself. It is an instrument to further the objectives of the European Union and improve the lives of citizens in the Member States.

The operations and management of EMU are designed to support sustainable economic growth and high employment through appropriate economic and monetary policy-making. This involves three main economic activities:

- Implementing an effective monetary policy for the euro area with the objective of price stability
- Coordinating economic policies in Member States
- Ensuring the smooth operation of the single market

Why are these activities important?

Monetary policy involves influencing interest rates and exchange rates to benefit a country's economy. This is achieved through a central bank controlling the supply of money in the economy. However, if each EU Member State operated its own monetary policy, then the single market would be much less effective, trade could be disrupted and the benefits would be fewer.

For this reason, under EMU, monetary policy is closely coordinated, and within the euro area it is centralized and independent.

Member State governments control other economic policy areas. These include fiscal policy that concerns government budgets, tax policies that determine how income is raised, and structural policies that determine pension systems, labour- and capital-market regulations. However, EMU brings more economic integration, and the euro area even more so. As a

consequence, economic policy-making becomes a matter of common concern to all Member States. To ensure the smooth operation of the EU economy as a whole, it is important that Member States coordinate their economic policies with the common objective of stability and growth.
As well as bringing the benefits of economic stability, EMU and the single currency also support a more effective single market which benefits citizens and enterprises. If national economic policies act to discourage the free movement of goods, services, capital and labour, then these benefits, including jobs and growth, would be reduced. Therefore, economic policy-making in the Member States should act to support the single market.
The Treaty defines the instruments for managing EMU. These instruments cover the three main economic activities described above.

4.4. Monetary policy

Monetary policy for the euro area is managed through the European Central Bank and the national central banks of the euro-area Member States, which together make up the Eurosystem. Decisions on monetary policy in the euro area can only be taken by the Governing Council of the ECB, which comprises the governors of the national central banks of the euro-area Member States and the members of the ECB's Executive Board. These decisions are made free from outside influence.
The Treaty lays down the ECB's mission which is to ensure price stability within the euro area. The ECB aims to keep price inflation in the euro area below but close to 2% over the medium term. This 2% inflation target is considered optimal for promoting growth and employment.

The Stability and Growth Pact

Economic policy-making in Member States is coordinated in the Council. The Stability and Growth Pact (SGP), laid down in the Treaty, is a central element of this coordination. Adopted by the Council in 1997 and later revised in 2005, the SGP helps enforce fiscal discipline within EMU and ensure sound and sustainable public finances.

The SGP requires government deficits and debt to be less than 3% and 60% of GDP, respectively. Exceeding these limits can result in an excessive deficit procedure requiring the Member State to take corrective action. The euro-area countries can also be subject to financial penalties as a last resort. This constitutes the 'corrective arm' of the SGP. There are circumstances where excessive deficits are considered exceptional and temporary, such as when they result from a severe economic downturn or are due to the major impact of an unusual event outside government's control.

The SGP also has a 'preventive arm' which aims to avoid excessive deficit procedures and achieve fiscal consolidation through medium-term budgetary objectives. These are set by each Member State according to its particular economic situation and prospects, but cannot exceed 1% of GDP for euro-area Member States and those which participate in the exchange rate mechanism (ERM II), with a 0.5% of GDP budgetary correction towards the objective to be made each year. The preventive arm has no sanctions for those Member States which fail to meet their objectives, but rather counts on peer pressure to encourage governments to stick to the path towards sustainable budgets.

The Broad Economic Policy Guidelines

Wider coordination is achieved through economic policy discussions between Member States and EU institutions. This policy coordination is consolidated into the Broad Economic Policy Guidelines (BEPG) which are adopted by the EU Council on the basis of a Commission recommendation.
The BEPG are non-binding guidelines for the Community and each Member State aimed at promoting macroeconomic stability, sustainable finances, structural reform and the smooth functioning of EMU. The BEPG set the standard against which national and European economic policy-making can be measured.

5. Realizing the benefits of the euro

The benefits of the euro are diverse and are felt on different scales, from individuals and businesses to whole economies. They include: more choice and stable prices for consumers and citizens, greater security and more opportunities for businesses and markets, improved economic stability and growth, more integrated financial markets, a stronger presence for the EU in the global economy, and a tangible sign of a European identity as well.
The single currency brings new strengths and opportunities arising from the integration and scale of the euro-area economy, making the single market more efficient. Before the euro, the need to exchange currencies meant extra costs, risks and a lack of transparency in cross-border transactions. With the single currency, doing business in the euro area is more cost-effective and less risky.
The scale of the single currency and the euro area also brings new opportunities in the global economy. A single currency makes the euro area an attractive region for third countries to do business, thus promoting

trade and investment. Prudent economic management makes the euro an attractive reserve currency for third countries, and gives the euro area a more powerful voice in the global economy.

Scale and careful management also brings economic stability to the euro area, making it more resilient to so-called external economic 'shocks', i.e. sudden economic changes that may arise outside the euro area and disrupt national economies, such as worldwide oil price rises or turbulence on global currency markets. The size and strength of the euro area make it better able to absorb such external shocks without job losses and lower growth.

5.1. Consumer Benefits

There are multiple opportunities for EU citizens and consumers to benefit from the euro. These arise because the euro and its political framework, the Economic and Monetary Union, offer lower costs, stable prices, more transparency and economic stability.

Some of these consumer benefits are direct, such as easier-to-compare prices while shopping; others are indirect, such as the long-term benefits economic stability brings to interest repayments on a bank loan for a new car. In both cases, the opportunities the single currency offers are wide ranging, covering not only everyday transactions, but also employment opportunities and European citizens' quality of life.

The following are examples of these opportunities.

A more competitive market

The euro brings price transparency to the single market. Consumers can easily compare prices across borders and find the most advantageous price for a product or service – especially in the internet era – whether it is a pair of trousers or a high-end home cinema system. This is because increased price transparency has the effect of increasing competition between shops and suppliers, keeping downward pressure on prices in the euro area.

Stable prices

The euro has brought inflation down to a low and stable level. In the 1970s and '80s many EU countries had very high inflation rates, some of 20% and more. Inflation fell as they started preparing for the euro and, since its introduction, has remained around 2% in the euro area. Price stability means that ordinary citizens' purchasing power and the value of their savings are better protected, which helps make the future more certain.

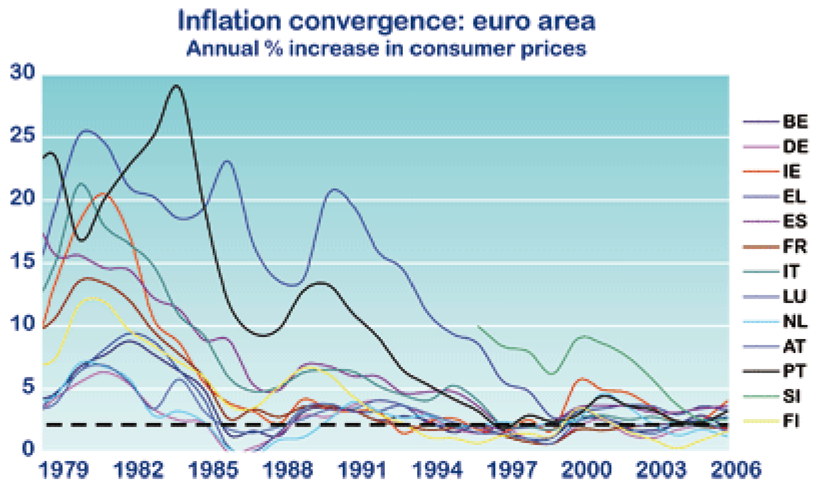

Figure 1

Source: *European Commission*

Easier, safer, and cheaper borrowing

Low inflation and stable prices are a key aim of the management of the euro-area economy. Because the European Central Bank acts to keep inflation low, interest rates are also lower. This means consumer loans are cheaper and future repayments are more predictable, so ordinary citizens can borrow more easily and cheaply, for example to pay for holidays or to buy a house. Mortgage rates have fallen from around 8%-14% in the early 1980s to an average of 5% now in the euro area, saving a borrower with a €100000 outstanding loan between €170 and €750 a month on interest payments.

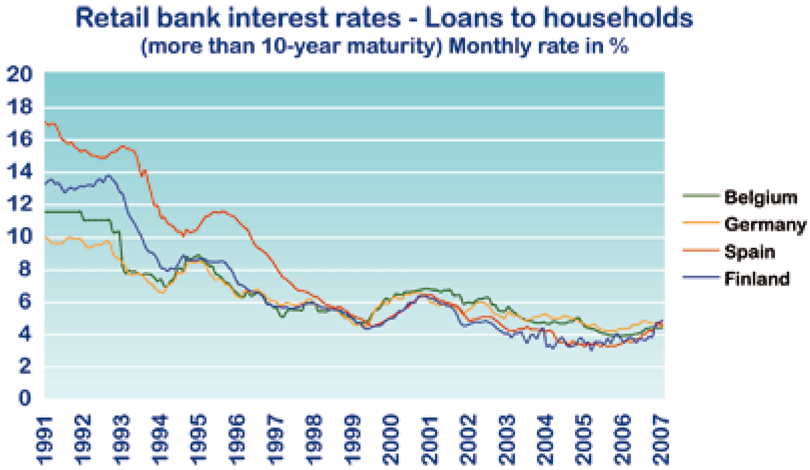

Figure 2

Source: *European Commission*

Lower travel costs

The costs of exchanging money at borders have disappeared in the euro area. This makes it cheaper to travel, whether on vacation, studying, or on business. In the 1990s, a person travelling through all the EU countries and exchanging money at every border would lose half their money in exchange costs – without making a single purchase. Today, a traveler starting out with €1000 would return home with the same amount in his or her pocket having travelled through the euro-area Member States. And the euro is readily exchanged in many countries outside the euro area as well – it is estimated that up to 20% of euro banknotes are circulated outside the euro area.

More growth and jobs

In a single market with a single currency, doing business across borders is cheaper for companies as they no longer need to include the risk of currency fluctuations into their prices nor to pay exchange costs. Previously, these costs amounted to around €20 to 25 billion annually within the European Union. Today, they have disappeared in the euro area. This helps release capital to invest in expanding and growing business and employing more workers, thereby benefiting jobseekers and their families. Since the euro was introduced in 1999, more than 10 million new jobs have been created in the euro area, compared with only 1.5 million in the previous seven years.

More public investment

It is not only citizens and business which benefit from cheaper loans: government borrowing is also less expensive, as interest payments on national debt are lower. The money saved can therefore either be used for investment in new infrastructure, or to boost research spending for jobs and growth, or for improving welfare and pension systems, or to reduce the tax burden – depending on a Member State’s priorities.

5.2. Business benefits

The single currency benefits business in many ways, in addition to cutting costs and risk. It encourages investments and brings more certainty to business planning – thus allowing businesses to be more effective overall.

More cross-border trade

A direct benefit of the euro is that, within the euro area, there is no need for businesses to work in different currencies. A company can buy and sell throughout this area, paying and being paid in euro.

Previously, when doing business in another EU Member State, a company would need to take account of the risk of fluctuating exchange rates– i.e. the stated foreign currency amount on the invoice might change in value before being paid. This meant either export prices were higher, or companies were discouraged from exporting within the single market. This risk has now gone, as have the costs associated with exchanging different currencies. Before the euro, these exchange costs were estimated at €20 to 25 billion per year in the EU (as much as 0.3% to 0.4% of GDP) – much of it incurred as companies transferred goods, people and capital around Europe. With the euro, these costs have disappeared in the euro area, and this money is now available for more productive investment.

With no exchange risks and costs, cross-border trade within the euro area is encouraged. Not only can companies sell into a much larger 'home market', but they can also find new suppliers offering better services or lower costs – a development that is helped by the growth of e-commerce over the internet. Trade within the euro area is estimated to have increased between 4% and 10% since the introduction of the single currency.

Better borrowing, better planning, more investment

Before the euro, volatile interest rates meant unpredictable costs. With the euro, inflation has come down to a low and stable level, which also means low and stable interest rates. Firms can borrow more and more cheaply and can invest more confidently in the long term.

Long-term investment is further encouraged by the sound and prudent management of Economic and Monetary Union, which builds trust in the economy of the euro area and reduces uncertainty about the future. Companies can invest more in growth and new technologies rather than saving money in reserve in case of an economic downturn.

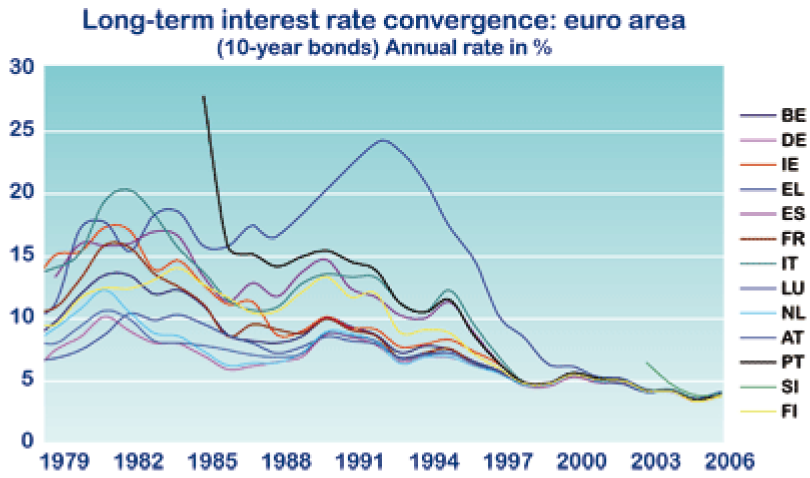

Figure 3

Source: *European Commission*

Better access to capital

The euro gives a large boost to the integration of financial markets across the euro area. Investors, such as banks, are no longer limited to local markets. Capital can flow more easily because exchange rate risks have disappeared and because financial market rules are being progressively harmonized – allowing investors to move capital to those parts of the euro area where it can be used most effectively.

More international trade

The euro is a strong international currency backed by the commitment of the euro-area Member States and the firm and visible management of monetary policy by the European Central Bank. The euro area is also a large and open trading bloc. This makes doing business in euro an attractive proposition for other trading nations, which can access a large market using one currency. Euro-area companies also benefit because they can export and import in the global economy while paying, and being paid, in euro – reducing the risk of losses caused by global currency fluctuations.

5.3. Economic stability and growth

Economic stability is desirable because it encourages economic growth that brings prosperity and employment, and is one of the main objectives enshrined in the management of Economic and Monetary Union and the euro.

Under Economic and Monetary Union (EMU), EU Member States closely coordinate their economic policies with the overall objective of maintaining economic stability. At the same time, the European Central Bank (ECB) conducts an independent monetary policy with the objective of maintaining low inflation in the euro area (below but close to 2%). Economic stability and low inflation create the necessary conditions for sustainable long-term growth, which benefits the euro-area Member States and their citizens.

Sound and sustainable public finances

Under Economic and Monetary Union, Member States must keep their government and debt deficits under specified limits (3% and 60% of GDP, respectively), according to the Treaty and the rules set out in the Stability and Growth Pact. These limits are also one of the convergence criteria a country must meet before it qualifies to adopt the euro. The aim is to ensure sound and sustainable public finances in the Member States of the EU and the euro area.

Sound public finance means that Member States live within their means and do not build up excessive debts that will burden future generations of taxpayers. In theory, governments could borrow heavily to invest and boost economic growth today. However, this is a short-term measure as debt repayments would harm economic growth and next generations in the future.

The commitment to sound and sustainable public finances is a commitment to ensuring economic growth and employment over the longer term. It also helps ensure that both today's and tomorrow's citizens are provided for fairly– for example, through adequate healthcare provision and pensions.

Better government budgeting

As with consumers and companies, governments and their electorates – their citizens – also benefit greatly from economic stability. Low inflation in a strong, well-managed euro area makes government borrowing less expensive. This means that interest repayments on national debt, which can be substantial, are reduced. This releases large amounts of taxpayers' money, previously used to repay the interest, for other purposes depending on national priorities; for example, for tax cuts, new public infrastructure, or welfare systems. In addition, economic stability allows governments to plan national finances, expenditure and revenues with more certainty.

More resistance to external shocks

Economic stability also makes the euro area more resilient to so-called external economic "shocks", i.e. sudden economic changes that may arise outside the euro area and disrupt national economies, such as worldwide oil price rises or turbulence on global currency markets. The size and strength of the euro area make it better able to absorb such external shocks without job losses and lower growth.

More cohesion

Economic stability benefits society, in particular social cohesion and the less well-off. Volatile changes in inflation and interest rates increase the gap between the richer and poorer groups and regions, as those with more wealth have more opportunities to protect themselves. With stable inflation and interest rates, the less well-off are better protected against the erosion of their wealth, their savings and their purchasing power.

A budgetary union as a protection mechanism

A monetary union in which each country keeps its own budgetary independences has been considered to be a very fragile system. In such a union, national governments issue debt in a currency they have no control of. This makes these governments vulnerable to movements of distrust that can lead to liquidity crises and forced defaults. It is now evident that, in principle, a budgetary union can solve this problem. The reason is that in a budgetary union, national government debts are also centralized into a union government debt (or at least a significant part of national government debt is). As a consequence, the union government acquires the characteristics of a "stand-alone" government; that is, it issues debt in a currency over which it has full control. Thus, the union government cannot be confronted with a liquidity crisis (at least if the union maintains a flexible exchange rate with the rest of the world, as in the example with the United Kingdom). This budgetary union also implies that there is a strong union government capable of forcing the common central bank into providing for liquidity in moments of crisis. In such a regime,

national governments, which would have lost much of their sovereignty, would also be protected by the union government.
It follows that a monetary union without a budgetary union is likely to function in a very different way from a budgetary union that is coupled with a budgetary union. The former can be labeled an “incomplete monetary union”, and the latter a “full monetary union”. It remains to be examined whether institutions can be created that, although they fall short of full budgetary and political union may nevertheless provide some insurance and protection for the member states of an incomplete monetary union, such as the Eurozone; and to analyze how these institutions can be designed in such a way to avoid the moral hazard problem. (De Grauwe, 2009)

5.4. Single financial market

Financial markets deal with the flow of capital and are vital to an open market economy because an efficient financial market provides for better use of capital. The introduction of the euro in 1999 provided major impetus to the integration of financial markets in Europe, thus making them more efficient and competitive, and reducing the costs of cross-border money transfers in euro.
A financial market is where savers and borrowers interact. Savers, such as individual citizens or companies, deposit their savings with a “financial intermediary” such as a bank or pension fund. These financial intermediaries, who consolidate the savings of many depositors, then lend money to borrowers. Borrowers come in all sizes: they may be small, such as a family taking a mortgage for a new house; or large, such as a multinational company borrowing to invest in a new production plant. Borrowers pay interest on their loans, which is returned to the savers

through the financial intermediaries as interest or dividends on their deposits.

Small may be efficient

Before the introduction of the euro, financial markets were largely national. Saving and lending was done mainly within the borders of a Member State. The country's savers would lend to the country's borrowers through nationally based banks and pension funds. However, the efficiency of nationally based financial markets was limited because the investment opportunities on offer, and the amount of competition between financial intermediaries (banks and other financial institutions) were also more limited.

Bigger is more efficient

The more integrated financial markets are, the more efficient the allocation of capital is because investments opportunities and competition are also greater, and capital can move around to where it can be used most efficiently.

The introduction of the euro in 1999 proved to be a powerful catalyst to the integration of financial markets and the creation of a much larger, more efficient single financial market, which brings many economic benefits:

- A single financial market allows individual citizens and companies to invest throughout the euro area to obtain the best return on their savings. It creates opportunities to borrow from across the euro area, seeking out the lowest cost for their loan. Investors can also spread risks more widely.
- The costs of financial intermediation, such as bank charges, are lower. In the euro area there are more banks and investment funds

and thus there is more competition between them. Lower costs encourage more capital flows.

- More capital is available to borrowers at a lower cost because there are more sources of capital. This makes the money they borrow cheaper and better tailored to the needs of the borrower.
- Because borrowing is cheaper this makes more capital available for further lending. This encourages citizens and companies to borrow more to invest – which creates more economic growth and more employment, and benefits the EU economy as a whole.

Building the single financial market

The single currency was a key step towards the creation of the single financial market. Its introduction immediately removed some obstacles to free capital flows – namely the costs associated with exchanging different currencies. Previously, these costs were a barrier to cross-border investments – today they no longer exist in the euro area.

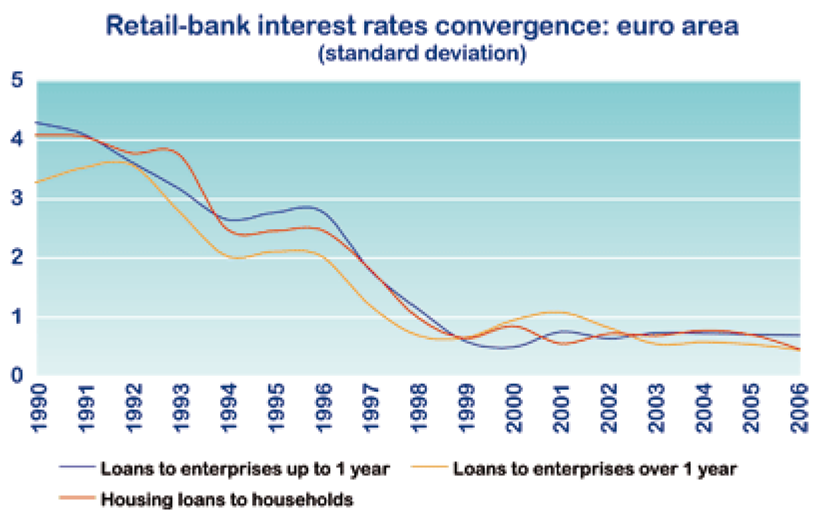

Figure 4

Source: *European Commission*

Backed by the Commission's Financial Services Action Plan – also launched in 1999 – the euro has resulted in a rapid expansion and integration of European bond and money markets. Since the introduction of the euro, cross-border bank deposits have increased, the yields on government bonds have converged, and the interest rates on retail loans, taken out by individual citizens, have also converged.

But harmonization of the structures and regulations of the financial market sector is also needed to ensure the remaining barriers are removed and efficiency is promoted. For example, barriers arising from different IT systems must be removed through common technical standards; legal issues for company mergers and takeovers must be resolved to enable consolidation among the financial intermediaries; and regulatory issues on how national markets operate must be harmonized to ensure full integration. The White Paper on Financial Services Policy (2005-2010), adopted by the Commission in December 2005, aims to achieve a fully integrated, open, inclusive and efficient EU financial market which completes the single market and contributes to improve EU competitiveness as part of the Lisbon reform process.

The Single Euro Payments Area

An important aspect of the single financial market is payments, which daily affect cross-border transactions of citizens and business. The costs of sending money in euro to another euro-area country have already been slashed by as much as 90% since the introduction of the euro and EU rules on cross-border euro payments in 2001.

These rules make the costs of making a payment in euro to an account in another Member State the same as the costs of a domestic transaction. This has applied to payment card transactions and withdrawals from ATMs since 1 July 2002 and to credit transfers since 1 July 2003.

The Single Euro Payments Area (SEPA), initially planned for 2010, was a further step in the same direction. An initiative of the European banking industry, it aims to further facilitate electronic payments across the euro area by making them as easy, safe and efficient as if they were done within one Member State and subject to identical charges. Citizens will benefit from faster and more secure transfers between bank accounts anywhere in the euro area, and will be able to use their bank debit card when shopping abroad as they would at home.

5.5. An international currency

The myriad benefits of the euro in the global economy arise from the size of the euro area, the integration of its economy, as well as its clear, joint commitment to sound economic policies. This makes the euro an attractive currency for other countries and trading blocs in the global economy. The euro is now the second most important world currency after the US dollar.

Supporting international trade

As the world's largest trading power, with an open economy and a stable currency, the euro area is an attractive destination for other trading nations. Third-country companies are therefore increasingly willing to do business in euro. This means that when euro-area firms export or import goods they can invoice and pay in euro – reducing their costs and the risk of losses caused by global currency fluctuations. Thus, overall, the euro facilitates and encourages trade with the rest of the world.

Foreign appeal

The euro is also attractive to foreign governments as a reserve currency because of its strength and the confidence it inspires. In this way, they can spread the risks to their foreign exchange reserves by holding euro as well as US dollars and other currencies.

This is of benefit to the euro-area economy because widespread holdings and a high demand for euro encourages third countries to price their exports in euro – thus reducing costs to euro-area members because there are no exchange rate costs.

In addition, since the euro is in demand internationally, government borrowing by euro-area members on international markets is less expensive because there is more competition to accept euro in debt repayment.

The share of the euro in global foreign exchange reserves has risen from 18% in 1999 to over 25% in 2007. The most significant increase can be found in developing countries, where holdings are now close to 29%, from 18% held in 1999.

One currency with one voice

The international financial institutions, such as the International Monetary Fund (IMF), the World Bank and the Organization for Economic Co-operation and Development (OECD), increasingly view the euro-area economy as a whole when dealing with macroeconomic matters.

They do this because the strength of the euro, the size of the euro area as a trading bloc, and the coordination of policy-making within the euro area, all mean that what happens in the euro area has growing spillover effects on the world economy.

This growing impact on the world economy is matched by a growing influence of the euro area within these international financial institutions. This gives the European Union a stronger voice in the world.

5.6. A Symbol Of European Identity

The euro, a symbol of European identity, is one of the strongest tangible symbols of European integration and the shared values of Europe, the European nations and Europeans themselves.

The history of the European Union has been one of growing integration between Member States, covering a huge range of social, economic and political issues. Many of the initiatives for integration have been aimed at building the single market and allowing goods, people, capital and services to move freely within the Union.

Significantly, implementation of the single currency was not only an economic decision; it was also a political commitment by the EU Member States to work together. This commitment is shown in the great efforts that were made by the Member States to achieve economic convergence before adopting the euro.

Economic and Monetary Union is based on the Member States' commitment to work together. This is possible through a number of mechanisms that facilitate policy coordination and close co-operation. One example is the Eurogroup that brings together euro-area ministers, while another is the Stability and Growth Pact (SGP) which helps promote common solutions to shared problems and opportunities.

Along with more political integration, the euro is also part of building a European identity among its citizens, alongside the national identities that preserve European diversity. Indeed, the “united in diversity” nature of the European Union is also seen in the euro coins, with common designs on one side and a country-specific design on the other.

6. Weathering The Storm: EMU During The Crisis (2007-2010)

The financial turmoil that started in August 2007 has been largely recognized by observers as a turning point and litmus test for EMU.
For the first time since its launch, the ability of EMU to mount a swift and coordinated response to external shocks has been stress-tested on a massive scale. This has presented a whole new set of challenges to EMU and its institutional structure. The next Section attempts to capture the dynamics of EMU between 2007 and 2010 by taking a micro-approach and focusing more specifically on the respective role of the institutions and of Member States' interests in shaping the crisis response. The subsequent Sections will analyze in turn the response of EMU to the financial crisis (Section I) and to the sovereign debt crisis (Section II).

6.1. Policy Coordination Initiatives During the Financial Crisis

The situation in which the EU has found itself since the outbreak of the crisis has been characterized by numerous (positive and negative) spillover effects from national policy actions into areas such as liquidity support, recapitalization of banks and fiscal policy (Quaglia, Eastwood and Holmes 2009: 67). The EU has traditionally been based on a set of rules (for instance, competition policy), compliance with which is ensured by the Commission and the ECJ. However, the rule-based system in place at the beginning of the crisis was not tailored for such extraordinary circumstances. The coordination by the EU of national responses to the crisis could not revert to rules, and some discretionary action was thus required. This could have implied a severe risk of a vicious spiral of “beggar-thy-neighbor” policies like in the 1930s (involving inter alia unilateral devaluations and the reintroduction of import levies) – something which the EU has successfully mitigated.

This is amply illustrated by the Irish example (Glöckler 2009). Shortly after the collapse of Lehman Brothers, the Irish government announced a guarantee that would “safeguard all deposits, covered bonds, senior debt and dated subordinated debt” (Irish Ministry of Finance 2008) with six Irish financial institutions. This decision was aimed at avoiding bank runs and a meltdown in the domestic financial sector and was thus fully rational from an Irish political perspective. However, it ignored the potential “externalities” of this decision, notably the fact that Ireland, and the Irish financial system, are part of the euro area and EU financial market. If other EU countries had attempted to “maximize their utility” by announcing measures of that type, it would have led to a fragmentation of the integrated financial and money markets: savers would naturally have withdrawn their savings from banks in countries where these were not guaranteed by the State and channeled them to banks in countries where they were. Had this spiral of financial sector “beggar-thy-neighbor” measures escalated, the integrated financial market would have re-fragmented and renationalized into individual national financial markets. The outcome would have been clearly sub-optimal from a pan-European perspective.

The swift reaction of EU institutions contributed to remedying this problem – albeit only partially. On 7 October 2008 the ECOFIN Council committed to take all necessary measures to protect the deposits of individual savers (EU Council 2008). A week later, the European Commission (2008) brought forward a proposal to promote convergence of deposit guarantee schemes. It was aimed at avoiding competitive distortions, inter alia, by increasing the minimum coverage level, and was adopted in March 2009. Nevertheless, this revised directive was not without limitations since it set a minimum, not a maximum, for such schemes in the Member States. In addition, it did not regulate guarantees in respect of non-deposit liabilities (Quaglia, Eastwood and Holmes 2009: 76).

A number of similar initiatives have been taken at the EU level to ensure that the design of national stabilization measures to resolve the financial turmoil does not lead to negative spillover effects and that a level playing field is maintained across the EU (see Appendix I).

These policy coordination measures have not been confined to the banking sector. The Commission also stepped in to sustain the real economy by adjusting its framework for State aid to support access to finance. Under this framework, State aid rules are applied "in a way that achieves maximum flexibility for tackling the crisis while maintaining a level playing field and avoiding undue restrictions of competition" (European Commission 2009). In December 2008, moreover, the European Council agreed an EU-wide economic stimulus of around €200 billion. The so-called "European Economic Recovery Plan" (European Commission 2008) was made up of budgetary expansion by the Member States worth €170 billion and EU funding in support of immediate action worth €30 billion.

Nevertheless, some scepticism persists among observers as regards whether this was a genuine EU response or whether it was not simply a case of the EU coordinating national responses (Glöckler 2009). For instance, in respect of fiscal policy the principles and guidelines of the European Economic Recovery Plan were rather vague, leaving the magnitude and timing of fiscal impulses mainly at the discretion of national governments (Quaglia, Eastwood and Holmes 2009: 83). In the field of competition policy, the European Commission could not prevent the rescue packages, e.g. for banks and the auto industry, from being organized largely along national lines. In institutional terms as well, as former Commission President Jacques Delors critically argues, "*when the crisis actually began, it seemed (...) to prove the intergovernmental method over the EU method (...) the fact that the initiative came from governments and not from the EU institutions will weigh heavily in the future*" (Delors 2010: 17). Indeed, the measures contained in the Paris Declaration (see Appendix I) were very much driven by national governments. Some observers point out that the Commission did not play a central role in this initiative, but provided support via its existing infrastructure for cooperation between governments. In that sense, the fact that an EU umbrella could be opened at the urging of the Commission as cover for the agreed set of measures had more to do with the coincidence of the EU Presidency being in the hands of an activist French government, rather than a genuine capacity for action on the part of supranational governance structures (Glöckler 2009).

What do these examples of collective action show? Rational choice theory would have predicted, under the severe circumstances in which the Member States found themselves, a myopic, protective, "national-interest-first" policy response, with little regard for the negative spillovers into the other EU and euro area countries. However, there has been no meltdown of EMU. The EU/EMU framework has reacted in a pragmatic and flexible manner to the extraordinary conditions with which it was faced. One of the main reasons why the crisis has not deteriorated into a 1930s-style spiral of "beggar-thy-neighbor" policies was the existence of supranational institutions able to shape the Member States' behavior. The Member States agreed to comply with some common minimum rules when trying to mitigate the effects of the crisis. Through the issuing of common guidelines, the EU institutions thus did play a significant role in remedying the "collective action dilemma".

Notwithstanding some caveats, it can still be argued that the EU's decision-making processes functioned quite smoothly during the financial crisis. In contrast, the episode of the sovereign debt crisis exemplified how an institutional framework based on decentralized policymaking, soft coordination and an insufficiently stringent enforcement of common rules displayed deficiencies in managing diverging national interests and perspectives so as to deliver a timely, resolute and, ultimately, market-calming policy response.

6.2 The Ad Hoc Response of EMU to the Sovereign Debt Crisis

Whereas, in the early stages of the crisis, shocks came mainly from "outside" in the form of common disturbances to the financial sector that affected all the Member States, the focus of the crisis shifted in early 2010 to shocks coming from "within". At issue were the failings of governments themselves, the adverse implications of which were magnified by the markets. A coordinated response proved much harder to come by. Euro area member countries were expected by financial markets, unless they allowed their common currency to be exposed to unprecedented stresses, to act in a way that the EMU framework had not anticipated, i.e. to provide financial support to each other to ensure the financial and economic stability of the whole euro area. But even more than that: the very foundation of monetary union expressly excluded that Member States assume each others' liabilities, via the "no bailout" clause (Article 125 TFEU). This implied that the euro area had no contingency plan for providing financial assistance to one of its members (Greece). Instead, the euro area had to coordinate 16 different countries who shared

no prior consensus on what balance should be struck between creating market impact, protecting taxpayers and limiting moral hazard.
In this context, the euro area's response resembled more of an ad hoc reaction than a structured process. Due to the shortcomings of the EMU framework, domestic political interests came to the forefront and figured prominently in official communications, impacting negatively on the financial markets. This translated into negative feedback loops between markets and policy actions. Markets looked to euro area governments to provide a unified direction, and reacted violently when political processes failed to deliver or resulted in disorderly communication from European policy-makers. Indeed, empirical evidence shows a correlation between daily spreads for 10-year government debt and significant political events (Carmassi and Micossi 2010). Further analysis suggested that inconsistent statements from politicians at critical junctures may have deepened the crisis by instilling further doubt in the markets about the ability of the euro area to coordinate itself (see chart, appendix II).
This reflects the fact that national governments and financial markets find it difficult to understand each other. "*On the one hand, markets do not understand why the governments of European countries are slow to adopt the necessary measures to solve problems, postponing decisions and creating uncertainty about their actual intentions. On the other hand, the political authorities often do not understand how the financial markets work; they deeply despise them but at the same time depend on them to finance their budgets*" (Bini Smaghi 2011).
Even the €110 billion package of bilateral loans to Greece of 2 May (in May 2010, euro area governments and the IMF decided, under stringent conditionality, to grant Greece a €110 billion loan, consisting of €80 billion of bilateral loans from euro area countries and an IMF contribution of €30 billion) under the specially created Greek Loan

Facility failed to establish market confidence and was paradoxically followed by increased market volatility and soaring bond spreads. One answer could be that the ad hoc nature of the euro area's crisis response led markets to continuously doubt its credibility, creating a self-fulfi lling downward spiral. Concerns about domestic fiscal conditions and debt sustainability even began to spread to larger euro area countries. Not until the far reaching policy decisions of the weekend of 7-9 May 2010 were euro area governments able to break this loop and get ahead of the curve. On this decisive weekend, the EU finally responded by creating two new crisis management instruments: the European Financial Stabilization Mechanism (EFSM) and the European Financial Stability Facility (EFSF). These two mechanisms did not breach the aforementioned "no bail-out" clause because the Member States thereby did not assume liabilities but instead provided loans under strict conditionality.

The euro area policy response to the sovereign debt crisis thus provides further evidence of the types of institutional change observed since 1999, namely layering. In fact, the creation of the EFSM and EFSF amounts to the introduction of new layers, added on top of the existing structure and relying on already functioning infrastructures (EWG as Board of Directors of the EFSF, EIB to handle treasury services). This demonstrates that, even when subject to a severe crisis, EMU continues to evolve in an incremental way rather than creating a radically different arrangement from scratch.

6.3. Markets Are Far Superior In Making Economic Decisions Compared To Political Planners

EU officials would of course, believe that it is impossible for an EMU country to become insolvent. Hence, all that is needed is that countries such as Greece stick to their adjustment programs. If the market does not believe in the success of these programs, then the public sector should take over the funding until success of the programs becomes visible. This argument implies that the political planners have the better foresight of both the future economic and political developments. No doubt, markets can be wrong for an extended period of time, as the recent experience of the inflation of the credit bubble has shown. But markets correct eventually, something that cannot be said for political planners. This is why economic history has shown markets to be far superior in making economic decisions compared to political planners.

6.4. Looking Forward

Impact Of The Crisis On EMU: Will The Crisis Be "Wasted"?

It has been said that "a crisis is a terrible thing to waste" (Paul Romer, November 2004). In a similar vein, expressions such as "critical juncture" or "window of opportunity" flourished in 2010 in the public pronouncements of European policy-makers. Empirically, a number of discernible signs, both in the field of economic governance and of financial supervision, indicate that the crisis has provided a genuine reform impetus.

On the one hand, the so-called "Van Rompuy Task Force" was established in March 2010 by the European Council. It was chaired by the President of the European Council and composed of representatives of the

Member States, the rotating Presidency and the ECB. Its official mandate was to "*present to the Council (...) the measures needed to reach the objective of an improved crisis resolution framework and better budgetary discipline, exploring* ***all options*** *to reinforce the legal framework*" (European Council 2010a). It recognized the need to take a broad view of governance that encompasses fiscal policy, competitiveness and crisis management. It delivered its report on 21 October 2010, while the Commission (2010) presented its legislative proposals on 29 September 2010.

Among the numerous proposals presented by the Member States and the EU institutions in the framework of the Van Rompuy Task Force, some would have been inconceivable in "normal times" as they touch the very core of national sovereignty. For example, Germany and France suggested in their joint proposal the suspension of voting rights for countries not complying with the Stability and Growth Pact (Lagarde and Schäuble 2010). Several Member States also proposed the creation of a Eurobond. These two proposals are quite far-reaching in terms of loss of national sovereignty. Before the crisis erupted, they could only be found in the academic realm, certainly not on the EU political agenda. The crisis has thus extended the boundaries of the public debate beyond what was politically conceivable under normal circumstances.

Another telling example of this impetus for change is the ongoing reform of the financial supervisory architecture. Even in the recent past any reform endeavor in this field had been strongly resisted by national authorities. By exposing important failures in the Lamfalussy structures, the crisis has clearly accelerated their overhaul and is bringing about a new financial supervisory architecture, i.e. the European System of Financial Supervision. The package agreed upon by the EU co-legislators in autumn 2010 foresees the creation of three European Supervisory

Authorities (ESAs) – each of them being in charge of overseeing a sector of the financial system (banking, insurance, securities and markets). The ESAs are responsible for developing technical standards with a view to a single EU rulebook and have the power to ensure the consistent application of EU rules across national jurisdictions. In addition, a new body was created in the form of the European Systemic Risk Board (ESRB). The ESRB is responsible for macro-prudential oversight of the European financial system as a whole – an area which was clearly missing before and during the crisis. It monitors and assesses systemic developments that could pose potential threats to financial stability and has the power to address warnings and recommendations to a national or European authority.

All of this seems to indicate that the crisis is accelerating institutional development. Does that mean that the EU and the euro area are on the brink of moving towards a radically new governance framework for their economies and financial sectors, as demanded by some observers (De Grauwe 2010)? In fact, many institutionalists divide the flow of historical events into periods of continuity punctuated by critical junctures, i.e. moments when substantial institutional change takes places thereby creating a "branching point" from which historical development moves onto a new path (Hall and Taylor, 1996: 942). Does the crisis represent such a "branching point" and is EMU moving onto a new path?

Probably not. In all likelihood, a fundamental overhaul of the existing EMU structure cannot be expected and the institutional changes to be anticipated will be of a rather gradual nature at best. As President Van Rompuy had put it, "*there will be no sudden jump to a quasi-federal system with EU taxes, Eurobonds, etc. One may regret it, for reasons of constitutional logic or economic efficiency, but it is politically excluded in almost all (if not all) Member States*" (Van Rompuy 2011). This difficulty of shifting European institutional structures towards greater integration is due to the fact that the EMU framework did not involve any radical transfer of powers other than monetary policy to the European level (Bini Smaghi 2011). During the first decade of EMU, the institutional framework has thus evolved gradually, subject to a certain path dependence, and institutions have proved to be sticky. The evidence in crisis response and thereafter seems to confirm that institutionalism will continue to be a valid theory for exploring the dynamics of EMU over the coming years. In other words, the institutional framework will continue to evolve via the processes of layering and redirection.

As regards economic policy coordination and surveillance, the Europe 2020 strategy is a prime illustration of this trend: it mainly consists of streamlining and redirecting the Lisbon Strategy and its existing policy instruments. National Reform Programs, which are assessed against the Integrated Guidelines for Economic and Employment Policies, continue to play a key role under Europe 2020 similar to their role in the Lisbon Strategy. The Integrated Guidelines, an instrument already prescribed in the Treaty, have been revised to reflect the new priorities of the Europe 2020 strategy. Their number has been reduced to 10 from the 24 under the Lisbon Strategy.

More specifically as regards the debate on economic governance, it soon became clear that, in the short term at least, no new institution would be created, and no step change would occur as regards the repartition of competences between the EU and the Member States. As an example, the European Council conclusions of 16-17 December 2010 "*agreed on the text of a **limited** amendment to the Treaty on the establishment of a future permanent mechanism to safeguard the financial stability of the euro area as a whole*" to be adopted by the simplified revision procedure (European Council 2010). Using the typology of institutional change, one can argue that the reform of economic governance is most likely to be dominated by the redirection of existing instruments and the layering of an additional instrument. In fact, the six legislative proposals from the Commission do not envisage building a new governance framework from scratch, but rely more on the existing SGP. On the fiscal side, the Commission proposes to revise existing Council regulations initially adopted in 1997, while the newly created framework for macroeconomic surveillance is clearly inspired by the SGP (e.g. preventive and corrective arm, Excessive Imbalance Procedure).

A closer look at financial supervisory reform also shows the incremental nature of the changes. The recently adopted legislation did not create the ESAs from scratch but upgraded the existing 3L3 committees by transforming them into authorities with legal personality and enhanced competences. As for the ESRB, it should be underlined that this new body has no legally binding powers and that it might be viewed as an umbrella organization for existing institutions (mostly national central banks and national supervisors of EU27). This is once again an example of how the institutional architecture of EMU evolves via the process of layering. The existence of a legislative review clause confirms that the financial supervisory architecture has not reached its final shape and will be subject to further incremental changes.

Institutionalism also provides interesting insights by arguing that gains from cooperation are the main determinant of institutional development (Hall and Taylor 1996: 945-946). Applying this assumption to financial supervisory reform makes it possible to understand why a "big bang" approach – such as the creation of a single supervisory authority – cannot be expected. The crisis has certainly revealed the costs of insufficiently harmonized financial regulation and supervision and thereby demonstrated the benefits of more integrated structures. As the Turner Review of the UK Financial Services Authority points out:

"*The current arrangements, combining branch passporting rights, home country supervision, and purely national deposit insurance, are not a sound basis for the future regulation and supervision of European cross-border retail banks (...) Sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration*" (FSA 2009: 101).

There seems to be a general consensus among EU institutions about the gains stemming from the "more Europe" option. At the same time, these benefits are associated with losses of national competences. Following a rational choice logic, the Member States will agree to a deeper level of integration until the point where their marginal utility (i.e. gains from more integrated supervision) is outweighed by the marginal cost (i.e. loss of competences). This is amply illustrated by the compromise over financial supervisory reform, where the direct supervision of cross-border financial institutions by the ESAs and the application of the so-called "safeguard clause" were among the most contentious issues. In these two cases, a significant loss of competences on the part of national supervisory authorities and a limitation of national fiscal sovereignty were respectively at stake. As the Member States are still reluctant to transfer too many competences to the EU level, the financial supervisory architecture could not be subject to any "revolutionary" change. This amply illustrates the force of one "reproduction mechanism", namely the lack of interest in change shown by the dominating actors.

These empirical observations are fully in line with one of the main predictions of the new institutionalist literature, namely that policymakers cannot go for a "breakdown and replacement" single-handed reform because this would not be sustainable and would eventually lead to a reaction bringing back old institutions (Guardiancich 2009). Institutional reforms therefore have an inbuilt bias towards incremental change, as the more sustainable and efficient form, rather than “clean slate” approaches. Even the most severe financial and economic crisis since the end of the Second World War is likely to verify this prediction.

As a conclusion to the above, first of all, the fact that EMU will broadly remain on the same path decided in Maastricht is not negative as such. The decisive issue in order to bring EMU back to sustainable growth and fiscal discipline is to address the main shortcoming of the EMU framework so far, i.e. the internalization of the EMU dimension into the Member States’ rational choices. This can be achieved while remaining on the same path and without going for a “big bang” approach. For instance, the new supervisory framework will be successful if it succeeds in compelling its various components (especially the national supervisory authorities) to internalize the European dimension when exercising their prerogatives.

7. Conclusion

In this paper, the basic and most important lines of the history of Economic and Monetary Union have been discussed in detail. Such are the creation of the single currency, as a symbol of "European identity", and the road towards the today's Economic and Monetary Union and the euro area; the latter is divided into four phases and analyzed separately. Next, follows a small and compact analysis of EMU during the Crisis of 2007-2010 and the issue of the "wastefulness" - in terms of *history's lessons*- of the Crisis is touched, regarding its impact on EMU.

In most of the part of this work, it has been also examined the issue of a monetary union as an effective and functional system for both economic growth and stability, concerning every one and each member state in it; emphasizing on Euro-zone countries. The different aspects supporting the idea of an economic and monetary union such as European Union are analyzed in detail. Special attention has been paid considering all the factors that lead a European country to join or not the single currency, i.e. the euro, as far as inflation, debt, institutions, growth, stability and solvency issues are concerned.

There are several reasons why countries might find it costly to join a monetary union (especially by the fact that they lose their national monetary policy instrument). The analysis known as the theory of optimum currency areas (OCA) has come under critism. This critism has been formulated at different levels. First, one may question the view that the differences between countries are important enough to bother about. Second, use of national monetary policies, including the exchange rate instrument, may not be very effective in correcting for the differences between nations. Third, not only may monetary and exchange rate policies be ineffective, but also they might do more harm than good in the hands of not benevolent politicians.

Nevertheless, in the above theoretical approach, the idea of an effective EMU is supported, to the extent that the Euro Area is officially the second largest currency area worldwide. Therefore, considering the euro as an anchor currency for other smaller or weaker currencies, the benefits and gains from the single currency outnumber the disadvantages and some losses which cannot a member state avoid.

However, reality has shown, as the EU Member States are still reluctant to transfer too many competences to EU level and therefore create a "full monetary union" (De Grauwe, 2009), the financial supervisory architecture could not be subject to any "revolutionary" change.

Moreover, as discussed in the above analysis, institutional reforms have an inbuilt bias towards incremental change, as the more sustainable and efficient form, rather than "clean slate" approaches.

The study of the workings of a monetary union is fascinating. So many new ideas are still to be discovered and analyzed.

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9. Appendices

Appendix I

Policy Coordination Measures In Support Of The Financial Sector During The Crisis

At the euro area summit in Paris on 12 October 2008, the euro area countries adopted a concerted action plan with the aim of restoring confidence in the markets and promoting the proper functioning of the financial system. The plan consisted of a euro area umbrella of guiding principles and common intentions for the design of national responses with a view to upholding the common market. It entailed four main points: (i) harmonizing the provision of retail deposit insurance; (ii) issuing government guarantees for bank debt securities; (iii) making funds available for bank recapitalizations; and (iv) providing asset relief measures. A few days later, on 15 and 16 October, the European Council endorsed the principles laid down in the Paris Declaration as applying to the single financial market in the EU.

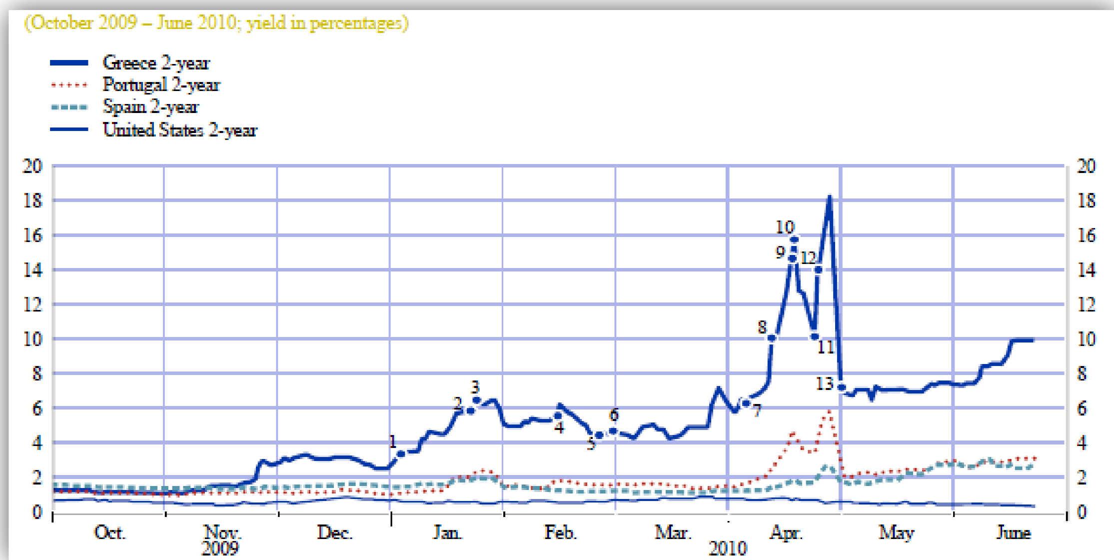
In close cooperation with the ECB, the European Commission has provided guidance to the Member States on the implementation of these common principles. In its "Banking Communication" issued in October 2008 (European Commission 2008), it provided a framework for Commission approvals of State aid schemes and ad hoc rescue measures for banks. It allowed for a tailor-made application of State aid rules given the exceptional circumstances, while attempting to limit distortions of competition in the Single Market. In December 2008, the Commission also adopted a Communication on the recapitalization of financial institutions (European Commission 2008). With a view to complementing the Commission initiatives, the ECB Governing Council issued recommendations on government guarantees for bank debts (European Central Bank 2008) and on the pricing of bank recapitalizations (2008). It also drew up guiding principles for bank asset support measures.

In February 2009, the ECOFIN Council agreed that, in order to safeguard banking sector stability, in specific cases measures to deal with impaired assets could complement government guarantees for bank debt and recapitalizations. Drawing, among others, on the input of the ECB (European Central Bank 2009), the Commission issued a Communication on the Treatment of Impaired Assets in the Community Banking Sector (European Commission 2009). While leaving the exact nature of an impaired asset scheme up to each Member State, the Communication lays down conditions in order to ensure a level playing field in Europe.

For a full overview of the measures taken, please consult ECB (2010).

Appendix II

Chart: Problematic Interaction Between Politics and Markets



1. 14 Jan. 2010 Greece claims it will cut budget gap to 2.8% of GDP in 2012 from 12.7% in 2010

2. 2 Feb. 2010 Prime Minister Papandreou says the government will extend public sector wage freezes

3. 3 Feb. 2010 EU Commission says it will back Greece's budget gap reduction

4. 24 Feb. 2010 One-day general strike against Greece's austerity measures

5. 5 Mar. 2010 New package of public sector pay cuts and tax increases

6. 11 Mar. 2010 Public sector workers strike

7. 15 Apr. 2010 Euro zone finance ministers approve €30 billion emergency aid mechanism

8. 22 Apr. 2010 Moody's downgrades Greece sovereign rating to junk

9. 27 Apr. 2010 S&P downgrades Greece sovereign rating to junk

10. 28 Apr. 2010 Ban on short-selling Greek shares in Athens

11. 2 May 2010 Greece receives €110 billion aid package over three years

12. 4 May 2010 Public sector workers stage nationwide strikes

13. 9 May 2010 Overnight session results in €900 billion aid package from EU, ECB, and IMF

Sources: Bloomberg and Morgan Stanley Quarterly Short-Term Credit Market Update, 4th Quarter 2010

Appendix III

The History Of Economic Integration In Europe: Timeline Of Major Events

Europe's Historic Timeline	
1951	European Coal and Steel Community → 1.)Preferential Zone
1957	Treaties of Rome: — European Economic Community EEC → 2.)Free Trade Area — European Atomic Energy Community EURATOM — European Coal and Steel Community ECSC
1960	European Free Trade Area: Founding members were the "Outer seven": Austria, Denmark, Norway, Portugal, Sweden, Switzerland, UK
(1965) 1967	Merger Treaty: ECSC, EURATOM and EEC merged into European Community EC → 3.)Customs Union
1972	Exchange Rate Mechanism (ERM): European Currency Snake
1973	Northern Enlargement 1: Accession of Denmark, UK and Ireland
1979	European Monetary System (EMS), including ECU as a basket currency
1981	Southern Enlargement 1: Accession of Greece
1985	Southern Enlargement 2: Accession of Spain and Portugal
1985	Schengen Treaty signed. Schengen area came into existence 10 years later in 1995
(1986) 1987	Single European Act - First major Treaty revision since 1957 - Agreement on full removal of all tariff and non tariff barriers in the European Single Market until 1992
1993 (1994)	European Economic Area: EFTA plus EU-12 minus Switzerland

1992 (1993)	Maastricht Treaty: → 4.)Common Market; Treaty Reform – three pillars: - EC (supranational) - Common Foreign and Security Policy (CFSP, intergovernmental) - Justice and Home Affairs (JHA, intergovernmental) Agreement on 3 stages to EMU: 1. 1990: Free capital movement 2. 1994: Convergence of macro policies 3. 1999: Launch of the euro
1995	Northern Enlargement 2: Finland, Sweden, Austria
1996	Broad Economic Policy Guidelines as a means for economic policy coordination. → 5.)Economic Union.
1997	Stability and Growth Pact
1997 (1999)	Amsterdam Treaty - More power for European Parliament, strengthening the rights of citizens
1999	Third Stage of EMU: European Central Bank, Launch of the euro as accounting unit → 6.)Currency Union
(2001) 2003	Treaty of Nice: Amendment of majority rules in the Council. Strengthening the principle of qualified majority, weighing population
2002	On 1 January, euro notes and coins are introduced.
2004	Eastern Enlargement 1: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic, Slovenia
2007	Eastern Enlargement 2: Romania, Bulgaria
2008	In December, EU leaders agree on a 200bn-euro stimulus plan to help boost European growth following the global financial crisis.
2009	Lisbon Treaty: Institutional reforms, more qualified majority voting, closer economic coordination between EMU member

	states, EU becomes legal personality
2010	Euro Crisis: EMU countries agree on support programs for Greece (2 May) and other EMU countries (9 May). Founding of EFSM and EFSF
2011	Signing of ESM Treaty
2012	Treaty on stability, coordination and governance in the Economic and Monetary Union
(2012) 2013	Cypriot financial crisis