RAstaNEWS
Macro-Risk Assessment and Stabilization Policies with New Early Warning Signals

European Commission

SEVENTH FRAMEWORK PROGRAMME

Macro-Risk Assessment and Stabilization Policies with New Early Warning Signals SSH.2012.1.3-1

Deliverable 6.4 Paper (T6.1)

Author(s)	Francesco Passarelli, Antonio Villafranca

Keywords	EU economic governance, Monetary policy, Fiscal policy

Abstract	This paper aims at uncovering the “holes” that the EMU’s progressive integration over the last three years left in the European “cheese”. The paper describes the politico-economic context in which the crisis took place, presenting a theoretical framework able to capture the complex dynamics of the politico-economic bargains occurring between OCA countries in general and among Eurozone members in particular. It then proceeds to review the rules EU policymakers adopted in trying to reach an orderly conclusion to the crisis, taking stock of progress done towards deeper political and economic integration, while trying to assess what was left to be done. In its conclusions, the paper advances what can be seen as a potential solution to make the Eurozone recovery more sustainable, all the while decreasing the likelihood and impact of future crises.

Distribution level	Public	**Status**	Final	**Version**	01
Contractual delivery date	8	**Actual delivery date**	10		

The RASTANEWS project is funded by the European Commission under the Seventh Framework Programme (SSH.2012.1.3-1).

Eurozone Flaws: Uncovering the *Holes in the Cheese*

Francesco Passarelli and Antonio Villafranca[*]

Introduction: the "original sin" of the euro

The economic crisis put a spotlight on the entire European project and, particularly, on its most astonishing achievement, the euro. The latter is marked by an "original sin", namely the misbelief that, by creating a single currency, one would prompt economic convergence in the whole region.[1] In other words, all the countries of the Eurozone were supposed to follow, sooner or later, the same economic path, no matter the inconsistencies between the EMU's institutional arrangements and those of an Optimum Currency Area (OCA).[2] Indeed, a partial economic divergence was taken for granted, but was expected to be benign and transitory. Differences in interest rates among Eurozone countries were supposed to encourage capital flows from "core" to "periphery" countries as a result of different investment opportunities.

This process should have been potentially beneficial for both investors and debtors. It was additionally considered transitory because capital flows were expected to decrease as soon as differences in interest rates narrowed and catching-up processes gained momentum. In a nutshell, the initial economic divergence was believed to be a precondition to, and suitable for, regional convergence in the medium run. However, the crisis clearly showed that this happened only partially, if ever, also because periphery countries often directed capital inflows to support domestic demand and internal standards of living instead of productive investments.

In this paper we claim that the lack of convergence is due, in addition to strictly economic factors, to politico-economic factors; namely, a fundamental inconsistency in the institutional structure of the Eurozone and the EU as a whole. This structure persistently leads to sub-optimal

---

[*] **Francesco Passarelli** is Associate Professor of Political Economy at University of Teramo and ISPI Senior Associate Research Fellow; **Antonio Villafranca** is ISPI Senior Research Fellow and Head of the European Programme. The authors wish to wholeheartedly thank Gianluca Flego (Research Assistant, Bocconi University) and Matteo Villa (ISPI Research Assistant, University of Milan), for their key contributions to this paper.

[1] For further reference, see C. Altomonte, A. Villafranca (2010), *Not Only Public Debt: Towards a New Pact on the Euro*, ISPI Policy Brief, n. 198.

[2] For a literature review on OCAs, see J. Horvath (2003), *Optimum Currency Area Theory: A Selective Review*, Bank of Finland, Discussion Papers, n. 15. For a critique of the approach focusing on the Eurozone, see P. De Grauwe, F.P. Mongelli (2005), *Endogeneity of Optimum Currency Areas: What Brings Countries Sharing a Single Currency Closer Together?*, ECB Working Paper Series, n. 468.

policy choices, which ultimately have worsened the crisis of the single currency. In particular, we argue that the current decision-making mechanism has two basic flaws: first, countries tend to choose rules too often; second, decisions come too late. When a member country adopts policies and behaviors potentially harmful to others (say excessive deficit), the Union tends to prevent such behaviors through rules, rather than more proportional mechanisms such as taxes (automatic sanctions) commensurate to harmful behaviors. Rules are less efficient than taxes, and the reason the EU adopts the former is that rules are more convenient to the majority of countries, when said majority is "virtuous". In addition, powerful countries have an incentive to procrastinate because they can better influence the decision-making process to their advantage when the decisions is made as late as possible. The rationale behind this is that when the decision is made late, all partners have a clear idea of what their interests are. By making a late decision the powerful countries can then take full advantage of their bigger voting power. This creates a peculiar conflict between small and big countries as regards the timing of decisions. The big ones have a higher incentive to procrastinate; the small ones have an incentive to make earlier decisions. This conflict is inherently generated by the voting system in the EU Council (i.e. weighted votes with super-majority). Of course in the context of a financial crisis there is a socially optimal timing in decisions, which trades-off between the incentive to launch clear and early signals to the market and the incentive to wait until all circumstances have been revealed. Arguably, the big countries tend to wait too much, with respect to optimal timing.

In this perspective, definitions commonly used to describe today's EU crisis seem inappropriate and misleading as they either confuse the symptom (e.g. sovereign debt crisis, banking crisis) with the disease or are simply too generic (e.g. economic crisis). As described above, today's crisis is rather a multifaceted phenomenon which can be better defined as a mixture of a "balance of payment crisis", reflecting diverging competitive trends on the economic side, and an "institutional crisis", reflecting an inefficient and ineffective power distribution and decision-making system on the political one. In order for the Eurozone to have its "original sin" absolved, decision-makers around Europe should clearly acknowledge the multifaceted nature of today's crisis and the patchy way in which they tried to put an end to it.

With a view to uncovering these "holes" in the Eurozone "cheese", this paper proceeds as follows. Section 1 describes the politico-economic context in which the crisis took place, presenting a theoretical framework able to capture the complex dynamics of the politico-economic bargains occurring between OCA countries in general and among Eurozone members in particular. Against this background, Section 2 offers a review of the rules policymakers adopted in order to reach a "would-be" orderly conclusion to the crisis, taking stock of progress done towards deeper political and economic integration, while trying to uncover the abovementioned "holes in the cheese" – namely, those areas in which Eurozone countries could do more and better (e.g. shifting from rules to taxes). Finally, Section 3 will not propose outright solutions, but will suggest possible ways to make the Eurozone recovery more sustainable, at the same time decreasing the likelihood and impact of future crises.

1. Credible commitments and crisis way-outs

One may claim that, apart from all the vocal divergences in the public debate, there is ultimately a fairly wide consensus around the basic recommendations to follow in order to reach an orderly exit from the euro crisis. Norms to be adopted might largely resemble, e.g., those that Germany itself

unilaterally implemented in response to its 2003-2004 crisis: a thorough effort to remove the root causes of uncompetitiveness through “structural reforms”, along with measures aimed at enhancing their political sustainability. In Germany, this famously made true by a series of labour market reforms (Hartz-Paket) which set the country on a path of diminishing productivity-weighted labour costs, hence increasing export competitiveness. The short-term social impacts of such reforms were mildened *via* temporary increases in public spending. Ironically, this led Germany breaking the 3%-deficit/GDP ratio rule, a key part of the same Stability Pact it had so strongly advocated.

Something similar may now be envisaged at the Eurozone level: weaker countries should implement labor-market and other reforms, so to set their current accounts straight, while cushioning social costs via an increase in public spending. Given the fiscal situation of periphery states, the funds to do this should probably flow from stronger countries themselves, through explicit or implicit transfers. To be acceptable and sensible, this should obviously be done on a strictly temporary basis: Germany would help Greece only to make it able to stand on its feet – and perhaps, once the country has recovered, it might even help Germany back one day. This is the rationale behind fiscal federalism as a welfare-improving mutual insurance against “asymmetric shocks”: each country agrees to help others when a shock hits only one or some of them. Many economists clearly recognized the Eurozone as lacking many of the conditions identified by Mundell as essential to Optimum Currency Areas (namely, price/wage flexibility, high labor mobility, or strong correlation of business cycles; see further details below).[3] After giving up exchange rate flexibility by adopting a common currency, it would become impossible for employment deficits due to shocks to be accommodated via purely-market mechanisms. A common view in the 1990s literature on EMU was that, therefore, it was vital that transfer arrangements to troubled areas complemented the currency union from the start. But policymakers did not follow this advice, leaving transfers subject to discretional decisions and to exhausting negotiations (especially in a context of sudden stops of capital flows from core to periphery countries).

The “transfers for reforms” scheme we have described as a possible solution to an OCA crisis has an obvious weakness: the risk that recipients of transfers just pocket them, fail to reform and eventually ask for more. The literature describes this as transforming “asymmetric shocks” into “asymmetric trends”, giving rise to “dependency syndromes”, or, more commonly, as leaving room to “moral hazard”. This outcome may come around through several paths: e.g. a shock may intervene, changing economic circumstances and prompting a government to infringe its previous commitments. Having to single out just an example, what is probably the most conspicuous – and relevant in this context – is once again the case of Germany. In 2003, following an economic slump of remarkable proportions for the country's strong record, the Schröder government – soon joined by France – was induced to increase spending and to infringe the 3% deficit/GDP clause.[4] This led to an Excess Deficit Procedure by the European Commission, which proposed a fine against Germany. Under the Italian Presidency, a coalition of big countries within the European Council, nevertheless, managed to block this. The maneuver was pushed through by treading over the opposition of many small virtuous countries – notably the Netherlands, with which Germany has now joined hands demanding rigorous enforcement of fiscal rules. As a result, the Growth and

[3] R.A. Mundell (1961), “A Theory of Optimum Currency Areas”, *The American Economic Review*, vol. 51, no. 4, pp. 657-665.

[4] New official documents have recently emerged, shedding an even clearer light on Germany’s role in loosening the SGP rules. See C. Reiermann, K. Wiegrefe, “Chancellor Schröder’s Legacy: Germany’s Leading Role in Weakening the Euro”, *Spiegel International*, 16 July 2012.

Stability Pact was significantly watered down, paving the way to a period of fiscal "laissez-faire" in several (especially Southern) countries, which bears responsibility for the crisis that followed. What is worth noting, in this junction, is that it was arguably sensible for Germany to infringe that rule at that time. Spending was a rational response to a downturn of the cycle, made on a strictly transitory basis, accompanied by sensible adjustment measures in a context of a relatively low debt/GDP ratio, and followed by a period of increasing competitiveness and sustained growth. Indeed, in a famous comment, the then president of the European Commission Romano Prodi had previously called the 3% deficit/GDP restriction "a stupid rule", having in mind its rigidity and inadaptability to cyclical components.[5]

It should be added that this "stupidity" was not chosen for its own sake, but sought to satisfy sensible criteria of simplicity, transparency, objectivity, and verifiability of the rule. This point is key in our analysis, and will be picked up again in the following discussion. But there is more: even without the interference of a shock, national governments find their defining constituency in national electorates, not in a supranational "European community" of sorts. A campaigning government always has a structural incentive to respond to its constituencies' temptations, i.e. spend transfers and leave costly reforms to successive generations.

Again, the pre-crisis Eurozone years provide a wealth of examples. The so-called "Euro-dividend" (i.e. the interest savings originating from the continental alignment of rates in the first years of the EMU) can be seen as a transfer of credit-worthiness from stronger economies to weaker ones. Nevertheless, the latter (most notably Italy and Greece) generally used its proceeds, by and large, for expenditure financing rather than debt reduction. Even sincere efforts towards fiscal virtue were, more often than not, squandered later on due to short-term electoral pressures. A most telling episode regards the second Prodi government (2006-2008). Thanks to a divisive crackdown on evasion by Economic Minister Tommaso Padoa Schioppa, in 2007 the government received approximately 6.5 billion euros in extra tax proceeds, which the media promptly dubbed "tesoretto" ("little treasure"). Amidst a white-heat public discussion within the quarrelsome left-wing majority (in which fiscally responsible voices were remarkably little heard), even one of the most EU-engaged Italian governments of the 2000s ended up devolving most of the "tesoretto" to current expenditure, of which a large part went to pensions and to the stabilization of temporary public employees – a traditional constituency of the left. The bitter irony is that even this all-in, last-trump attempt at consensus building could not delay the government's fall by much.

This leads to a further remark that is particularly relevant to these countries' political economy. One should bear in mind that the limited ability of governments to commit themselves to reforms is also an endogenous consequence of the lack of competitiveness that made reforms necessary in the first place. Indeed, bad economic performance implies constant pressure (and dependence) on governments to make up for employment scarcity. Politicians, on the other hand, need votes, and know they can reap benefits from their being privileged employment (or income) providers. Hence, uncompetitive countries find themselves, more often than not, in a situation of mutual entrapment between politics and large segments of the electorate. It is hard to expect consistent compliance with costly consolidation reform plans from already battered workforces, and from governments facing such a strong preference for spending.

For a number of reasons, then, uncompetitive countries find it extremely hard to engage credibly into long-term commitments to structural adjustment. Stronger countries anticipate all this and –

[5] BBC News, "Row over 'stupid' EU budget rules", 17 October 2002.

quite rationally – balk at transfers, thus making weaker countries' troubles worse. The latter, in turn, are left to bear the whole brunt of the adjustment, which makes them even more reluctant to reforms.

There are even more vicious byproducts of this situation. Two of them merit further attention: (1) the nature of reforms that are typically requested by "virtuous" countries, and (2) the apparent untimeliness of decisions, i.e. the fact that interventions seem to have a systematic tendency to being "too little, too late".

As for the first point, one may hardly miss that, as a rule, the focus is on relatively simple labor-costs, privatization, and fiscal issues. Nevertheless, it is pretty straightforward to say that the roots of uncompetitiveness reach much deeper than taxation, spending and wage levels *per se*, especially in countries for which structural problems did not, in the main, originate from a debt hangover in the private sector. Take the cases of Italy and Greece. Italy's economic performance in the 2000s was mainly driven by abysmal productivity dynamics, which worsened competitiveness despite stagnating wages. Greece, instead, had reasonable productivity dynamics during the euro years, but they were cancelled off by excessive wage increases, connected to a public spending spree and the labor-supply consequences of a generous pension system. It is delusory to think that the illnesses that gave rise to all this may be durably healed *via* simple wage cuts – at least to the extent that these are realistically attainable. What these two countries – as well as much of Southern Europe – need, instead, is for the relationship between public and private sector to be turned around, especially as regards the state's role in supporting productivity enhancement. For instance, education, at the primary or advanced stage, or "deep governance" issues such as corruption and efficiency of the judiciary, are major watersheds for these countries when compared to Northern Europe.

Quite evidently, though, intervening on such topics is a daunting task. They require high levels of state capacity, and especially the ability to carry on continued efforts for extended periods of time – in short, to commit oneself to the long-term. But, as the preceding examples made clear, this is precisely what troubled states can often hardly be trusted upon. It is therefore easy to explain why transferring states have a strong bias towards making the transfers shallower and more easily monitorable, and to make what at first might appear as short-sighted requests.

As regards untimeliness of decisions, on the other hand, this aspect was especially clear in the case of Greece. The country's bailout costs – and attached adjustment measures – soared from one of the Troika's rescue plans to the next, due to the ailing economy and exploding unemployment rates. It is widely recognized by now, even by primary actors in the crisis such as the IMF,[6] that its early stages should have been managed differently. Delaying rescue measures – also due to worries related to the balance sheets of German and French banks – only made matters worse, forcing to even larger interventions down the road.

Given the low-trust context that emerges from the examples, this is hardly surprising. Indeed, the literature has no shortage of theoretical arguments predicting that the absence of credible commitment strategies affects not only the possibility to conclude an agreement, or its contents, but also the time at which it is reached. For instance, Alesina and Drazen model a cost-splitting problem as a sequential game of war of attrition, predicting that agreement is suboptimally delayed and

[6] IMF, "Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement", *IMF Country Report*, no. 13/156, June 2013.

overall costs increased.[7] In addition, Schure et al. predict that, in negotiations over contracts of mutual assistance, powerful parties wish to postpone agreement after a shock hits, whereas weaker ones try to anticipate it, hoping to get better protection of their interests through signing in before being in need.[8]

It is easy to see that, in the case of Greece, mistrust drove the Troika to request "a pound of flesh", i.e. harsh fiscal austerity, as an act of goodwill in exchange for always insufficient quantities of aid.[9] This led to extreme resistance to adjustment, to a sharper economic downturn, and hence to more need for aid; what's more, it further decreased trust among various countries of the Eurozone. Summing up: feelings of abandonment and exploitation – i.e. mutual distrust – debase, delay, or outright impede the "tranfers vs. reforms" transaction, so to force all parties onto Pareto-inefficient outcomes. The upshot, as predictable, is slower (and likely unsustainable) recovery from structural imbalances, or no recovery at all.

Clearly enough, the absence of mechanisms of credible long-term commitment – especially on the recipient countries' side – poses an existential threat to the euro. The filling of these "holes in the cheese" is therefore a central task for the near future. The basic issue, given what we have seen above, is to make democracy time-consistent, i.e. overcome its strong bias towards obfuscatory, opportunistic, and especially short-sighted behavior. Hence, a careful design of community-level decision and implementation mechanisms turns out as a key issue on which the EMU stands or falls.

Against this background, what follows is a critical review of decisions taken and implemented so far by EMU leaders, with a view to placing emphasis on their potential inconsistencies and ineffectiveness.

2. Looking back: fixing the system but leaving some holes

As anticipated in Section 1, structural conditions drew policymakers (especially from "virtuous" countries) to prefer strict rules instead of progressive taxes/sanctions, and to adopt measures which were untimely at best. Nonetheless, the crisis made countries more eager to cooperate on certain specific topics, and EMU governance integration progressed significantly – although in certain areas more than in others.

In order to evaluate this process of coordination and competition between EMU Member States, this Section will try to point out some elements of the "ever closer" union that have been left out from the debate, or which were significantly diminished during the later stages of their negotiation before their final approval, thus making them unfit to solve the Eurozone crisis. In assessing how and why some areas saw more progress while others kept on lagging behind, one will stand a better chance at singling out the primary problems that need to be addressed in order to make EMU governance more coherent, and the decision-making process between Member States with conflicting interests more time-consistent.

2.1 Budgetary rules: leaving room for "interpretation"

[7] A. Alesina, A. Drazen, "Why are stabilizations delayed?", *American Economic Review*, vol. 81, no. 5, 1991, pp. 1170-1188.

[8] F. Passarelli, P. Schure, D. Scoones, *When the Powerful Drag Their Feet*, Department Discussion Papers 0703, Department of Economics, University of Victoria, 2007.

[9] B. Eichengreen, *Lessons of a Greek Tragedy*, Project Syndicate, 13 June 2013.

Budget rules are probably the area of EMU integration where most progresses have been made since the start of the euro crisis. Institutionally and politically, while temporary bailout capitals were being committed in order to prevent any country from leaving the currency union (see par. 2.3), it was easier to focus on strengthening common budgetary rules, on the one hand because it was an area that had been regulated since the inception of the euro, and on the other because "virtuous" countries consistently pushed towards that direction. However, if one takes into account the more-than-a-decade-old history of budgetary rules, a grimmer outlook emerges.

The third stage of the EMU began on 1 January 1999, and the Stability and Growth Pact (SGP) was supposed to go hand in hand with the introduction of the common currency. All Member States undertook to pursue the goal of a balanced or nearly-balanced budget and to provide the Council and Commission with stability programmes, to be produced and submitted annually. The SGP contained a multilateral surveillance procedure on public accounts that aimed at preventing imbalances, and an excessive deficit procedure that was intended to sanction states breaching the 3% deficit/GDP threshold (but not the 60% debt/GDP threshold).[10]

As presented in Section 1, problems on the implementation of the SGP turned out to be crystal clear immediately after the euro was circulated, with key countries such as France (2002-2004), Germany (2001-2005) and Italy (2001-2006) breaching the deficit limit and, at the same time, never being actually sanctioned for their infringements. In 2005 the EU Council was even forced to relax budgetary rules, by keeping debt and deficit ceilings while tying the excessive deficit procedure to more flexible parameters, such as cyclically-adjusted budgets and country-specific medium-term budgetary objectives.[11]

Eventually, the European crisis forced countries to revert the system to its stricter (and original) form, with now-virtuous countries such as Germany, the Netherlands, and Finland agreeing to provide bailouts only if coupled with stricter and legally enforceable budgetary rules. In this context, the Six Pack (5 EU regulations and 1 directive, which were proposed in September 2010 and finally entered into force on December 2011) made budgetary rules stricter for the whole of the EU and aggravated the possible sanctions to the 17 Eurozone members. Formally, it strengthened both the preventive arm of the SGP – by requiring states to make significant progress towards their medium-term budgetary objectives and imposing an interest-bearing deposit of 0.2% of GDP on non-compliant countries – and its corrective arm. An excessive deficit procedure can now be launched even against states exceeding the 60% debt/GDP threshold, while states exceeding it are required to reduce the excessive part of their debt by 1/20th per year. Failure to comply for Eurozone countries can result in a fine.[12] The new reverse qualified majority voting procedure also ensures that Commission decisions to sanction non-compliant countries immediately enter into force unless a qualified majority of member states decides to block it, thus making the sanctions process more supranational than before and making it harder for countries to avoid potential fines.

In terms of budgetary coordination, through the Six Pack and the following Two Pack (proposed in November 2011 and entered into force on May 2013), EU institutions retained

[10] Treaty on the Functioning of the European Union, artt. 121 and 126.
[11] EU Council, Presidency Conclusions, 23 March 2005. Available at: http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/84335.pdf.
[12] Regulations from 1173/2011 to 1177/2011, and Council Directive 2011/85/EU.

their power to make recommendations and issue warnings to national Parliaments, but every Eurozone member was required to submit its fiscal budget to the Commission even before presenting it to national Parliaments, by October 15th every year. Countries with excessive deficit procedures are required to follow an even stricter schedule.

The Treaty on Stability, Coordination and Governance (also known as *Fiscal Compact*), which was ratified by 25 out of 27 EU states, further strengthened Member States' commitments to balance their budgets in the medium term (even committing every Member State to "implement a balanced budget rule in their national legislation through permanent, binding provisions, preferably of a constitutional character") and increasing the enforceability of sanctions under the excessive deficit procedure.[13]

At the end of this *barrage* of legislation packages, one might legitimately ask to what extent stricter rules mirror actual enforcement. In fact, rigid agreements on rules and definitions still leave an open door to "flexible" renegotiations among Member States. Taking stock of the fact that as of September 2013 no sanction has been administered by the Commission, one cannot help but notice that in May 2013 six out of seven countries whose deadline to re-enter from an excessive deficit had expired (Spain, France, the Netherlands, Poland, Portugal and Slovenia) won themselves a deadline extension.[14]

The new and stricter budgetary rules still leave an open door to interpretation by using words such as "structural deficit" and "exceptional circumstances" which may institutionalise the flexibility that those very rules aim at reducing. The reason for this "bipolar" behaviour is simple: at the same time as core countries aimed at making sanction mechanisms more and more automatic, periphery countries managed to preserve some degree of flexibility. While this is explainable as the obvious result of a bargaining process, it risks exacerbating future tensions. Non-compliant countries can now legitimately make a case in front of the European Commission that their deficit is due to short-term circumstances and not structurally-related, postponing the necessary fiscal adjustments, in a process that keeps on leveraging the political power of each Member State against the judgments of the Commission.

While on one side improving coordination and possibly harmonization throughout the whole of the EU by making budgets more readily comparable, the new rules seem therefore to exacerbate the kind of brinkmanship that characterized the relationship between the Commission and many Eurozone countries since the inception of the EMU. The absence of a truly centralized, democratically legitimate and fiscally adequate centre in the Eurozone makes every country want to retain enough leverage against each other and the Commission. Stricter rules must apply to every other country, but should be interpreted flexibly when it comes to themselves.

It therefore comes as no surprise that a compromise is still lacking between the institutionalization of a rigid and binding system at the supranational level and the inter-governmental interplay in an ever-more-fragmented EMU.

---

[13] Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, 2 March 2012; entered into force on 1 January 2013.

[14] Only for Belgium did the Commission recommend that the Council decide that no effective action had been taken to put an end to the excessive deficit; the Council gave notice to Belgium to take measures to correct the excessive deficit on 21 June 2013. This is the final step before the Commission can recommend to impose a fine on the country, something that the Commission has never done so far.

2.2 The quest for macroeconomic convergence

In the original architecture of the EMU, one could find macroeconomic imbalance surveillance at almost the opposite end of the regulatory spectrum compared to budgetary and fiscal coordination. As fiscal rules were agreed upon, if very seldom enforced, macroeconomic imbalances were left aside. The macroeconomic debate inside the EU kept on stressing the positive elements that made the EMU resemble an OCA (see Introduction and Section 1) until at least the first quarter of 2010, when an important report by the Commission started to recognize potential problems and addressing critiques.[15]

As convergence never materialized, macroeconomic disequilibria were actually exacerbated by the European crisis. Core countries benefitted from good macroeconomic fundamentals and a surplus in their external position, as the crisis left them almost unscathed, while periphery countries plunged into the swamps of slow growth or outright recession, high unemployment and widening current account deficits.

As the crisis dragged on, the Commission and the Council started considering these persistent imbalances in competitiveness as something that should not be left to market forces (the same market forces that had almost pushed weaker countries, such as Greece and Ireland, to exit the currency union), and decided to create a mechanism to prevent and correct them. This was finally institutionalized in the macroeconomic imbalance procedure (MIP), which is contained in one of the Six Pack's regulations.[16]

The MIP is an annual process that starts with the publication by the Commission of an Alert Mechanism Report. Based on a scoreboard of eleven (originally ten) indicators, it serves as a first filter to select those countries in need of a closer analysis, which is subsequently carried out by the Commission in a country-specific in-depth review. This preventive arm is complemented by a corrective arm: the Excessive Imbalance Procedure (EIP). At its later stages, the EIP even contemplates the possibility to fine countries up to 0.1% of their GDP if they fail to comply with Commission's and Council's recommendations. As in the case of the excessive deficit procedure, the decisions for the EIP are taken following the reverse qualified majority voting procedure, so that countries need a qualified majority in order to block proposed fines from the Commission.

In the first two years of implementation (2011-2012), the Commission drafted an in-depth review for a total of 14 EU countries out of a potential 23.[17] Nonetheless, for none of these countries did the Commission open an EIP, evidently judging that these "excessive imbalances" were, in the end, not that excessive – owing to the economic crisis and, partially, to the necessary austerity measures that some countries had to take in order to rebalance their budgets. Interestingly enough, Germany, the country with a considerable external imbalance in absolute terms, was not considered among those liable of an in-depth

---

[15] EU Commission, *Quarterly Report on the Euro Area. Special Issue: The impact of the global crisis on competitiveness and current account divergences in the euro area*, vol. 9, no. 1, 2010.

[16] Regulation no. 1174/2011, "Regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area", 16 November 2011.

[17] Croatia still had to become an EU member, while countries that had already been bailed out and agreed to separate Economic Adjustment Programmes (Greece, Ireland, Portugal, and Romania by 2012; with the addition of Cyprus in 2013) are evaluated separately, so that the Commission cannot draft in-depth reviews for them.

review until November 2013,[18] because of a structural asymmetry inserted in the MIP: countries are labelled as “out of balance” if their current account is more than 4%/GDP in deficit, but only more than 6%/GDP in surplus. It seems that the Commission sees surplus countries as more virtuous than deficit ones, although the literature shows that spillover effects from excessive surpluses can exacerbate credit crunches in the deficit countries of a currency union.[19]

The EIP is still in its infancy, and probably needs a burn-in period before one can gauge its full effects on country compliance. In the meanwhile, one cannot help but welcome the fact that, finally, excessive imbalance corrections are shifting from a merely budgetary dimension to a more well-rounded macroeconomic evaluation.

2.3 Crisis management: the long-delayed path towards institutionalization

When Greece was first struck by its government-debt crisis in early 2010, the Eurozone was caught completely unprepared to face the situation in a collective and orderly fashion. Lacking institutional mechanisms to tackle the crisis, Eurozone member states had to first reach an agreement on whether Greece deserved to be saved. Should its debt be renegotiated and substantially cut, and should billions of euros be lent to the country at relatively low interest rates after market interest rates skyrocketed to unsustainable levels? As the rift between Eurozone ‘virtuous’ countries (e.g. Germany, the Netherlands, and Finland) and embattled ones (e.g. Italy and Spain, occasionally supported by France) widened, eventually European governments managed to avert the crisis. But, amid strong dissent about which institutions were actually needed in order to face the crisis, leaders only managed to reach tentative agreements and decided to rely upon *ad hoc* solutions; only through the years (consistently with the time-delaying factor anticipated in Section 1) would they manage to find a consensus and set up a permanent crisis resolution mechanism.

In 2010, the €110 billion first Greek bailout occurred under a direct bilateral agreement between Eurozone member countries and the International Monetary Fund (IMF). During the following months, Eurozone countries struck an agreement over the creation of a centralized facility that would manage a committed pool of financial resources by Eurozone member states: the European Financial Stability Facility (EFSF) came into operation on May 2010. Together with yet another facility, the European Financial Stability Mechanism (EFSM), the EFSF contributed to the Irish (November 2010) and Portuguese (May 2011) bailout programmes, while providing the second and third tranche of the Greek financial aid (for a total of €188 bln by the EFSF and €49 billion by the EFSM).[20] The financial contributions made to troubled countries by the EFSF and the EFSM obviously came with tight strings attached: the “bailed out” countries would have been closely monitored, and

[18] Germany’s 3-year average current account balance over GDP in 2011 was reported at +5.9%. The next year, Eurostat revised that figure upwards, but not on time to be considered an imbalance by the MIP. Actually, constant upwards revisions left Germany exceeding the 6%/GDP threshold *every year* since 2007: see European Commission, *Alert Mechanism Report 2014*, COM(2013) 790, p. 14. With a forecasted current account surplus at 7%/GDP in 2013, Germany appeared in the recently-published Alert Mechanism Report 2014 sporting a 3-year average surplus at 6.5%/GDP, which finally justified the start of an in-depth review to be concluded by Spring 2014; see also A. Villafranca, *Se la Germania impoverisce i suoi vicini*, ISPI Commentary, 14 November 2013.

[19] See for example F. Bruni, A. Papetti, *Bringing Money Back to the Real Economy: Room for a TARGET3*, RAstaNEWS publication, 2013, pp. 5ff.

[20] European Financial Stability Facility, FAQ, retrieved at http://www.efsf.europa.eu/attachments/faq_en.pdf.

had to implement a macroeconomic adjustment programme agreed upon between the country and the institutions bailing it out.

Although the way to cope with government-debt crises was progressively being centralized, both the provisional nature of the solution and the awkward subdivision between the EFSF (completely state-funded) and the EFSM (which was set up by the EU Commission and relied upon the EU budget as collateral) were problems that remained to be addressed.

In fact, the decision leading to the creation of a permanent crisis resolution mechanism for Eurozone countries was taken by the European Council back in December 2010. However, the intergovernmental treaty establishing the European Stability Mechanism (ESM) was only signed on 2 February 2012, and the facility was finally inaugurated on 8 October 2012, almost two years after the first agreement. In concrete terms, the ESM simply took up the work of the EFSF (it is actually composed of the same staff, and operates from the same headquarters in Luxembourg), thus providing loans and other forms of financial assistance to Eurozone member states. Although already contributing to the Cyprus bailout (which Eurozone countries agreed upon on March 2013), the transition from EFSF rescue and stabilization programmes to only-ESM ones was only completed on 1 July 2013, when the ESM legally became the sole mechanism for responding to new requests for financial assistance by Eurozone member states.[21] Together with the Cyprus bailout, as of today the ESM is also contributing a €100 billion loan to the Spanish government, which is using it to recapitalize the country's banking sector.[22]

Similarly to the EFSF, the agreement establishing the ESM authorizes it to: (a) provide loans in the framework of a macroeconomic adjustment programme; (b) purchase debt in the primary and secondary debt markets; (c) provide precautionary financial assistance in the form of credit lines. Its total subscribed capital, committed in different proportion by Eurozone member states, amounts to €700 billion, with €80 billion of paid-in capital. For legal and regulatory reasons, its effective initial lending capacity stood at €500 billion.

In addition to its initial mandate, on 21 June 2013 Eurozone finance ministers reached a compromise allowing the ESM to directly recapitalize Eurozone illiquid banks before they become insolvent. Despite being a first step in the right direction, there are wide margins of improvement. First of all, the ESM intervention will be capped at €60 billion (out of the aforementioned ESM total lending capacity of €500 billion),[23] and the ESM funds will only be allowed to be injected into banks that have already reached a core Tier 1 capital buffer of 4.5%; failing this, national governments would anyway be required to step in and recapitalize the bank up to this lower threshold. It would thus be ineffective in breaking the dysfunctional relationship between domestic banks and national governments. Moreover, the compromise sets even stricter eligibility conditions: the funds could only be used for those banks deemed "saveable" and "systemically important" by the ECB, which is also requested

[21] The EFSF would legally remain active in financing the ongoing programmes for Portugal, Ireland and Greece; ESM Press Releases, "ESM becomes sole mechanism for new financial assistance programmes to euro area Member States", retrieved at http://www.esm.europa.eu/press/releases/esm-becomes-sole-mechanism-for-new-financial-assistance-programmes-to-euro-area-member-states.htm.

[22] ESM, *Spain*, retrieved at http://www.esm.europa.eu/assistance/spain/index.htm .

[23] For comparison, the bailouts of Royal Bank of Scotland and Lloyd's cost around €75 billion, while the biggest banks of the Eurozone, such as Deutsche Bank and Crédit Agricole, would necessitate at least ten times as much money; se B. Fox, "Who pays the bills in a banking union?", *EU Observer*, 15 July 2013.

to certify the concerned national government would not be able to save them without compromising its fiscal sustainability. Even so, this country has to contribute at least 20% to any ESM recapitalization.[24]

To sum up, as the ESM starts to properly function, many question its ability to actually cope with new systemic crises. To make things worse, decisions to deliver financial assistance must be taken by consensus by members of the Board of Governors, which are nothing but the finance ministers of the euro area, i.e. direct representatives of member states.[25] Many fear that political disagreement could lead to an ESM governing body's deadlock. In addition, it is noteworthy that – during a transitional period that will only end in mid-2014 – even the €80 billion in paid-in capital by Eurozone member states is due in tranches. The ESM's full lending capacity will not be reached before April 2014.[26] Moreover, many observers have questioned the ability of a full-fledged ESM fund to effectively defend Eurozone biggest countries, considering that €500 billion is roughly equivalent to just one-sixth of the outstanding bonds issued by Spain and Italy together.[27] Finally, the ESM has already committed around €109 billion to Spain and Cyprus, so that its lending capacity will have shrunk by more than 20% before the time it becomes fully operational in mid-2014. Despite all this, the probability that Eurozone member states would agree to further funding seems meager.

2.4 Macro/micro transmission mechanisms: towards an effective banking union

Between October 2008 and October 2011, the European Commission approved €4.5 trillion of state aid measures to financial institutions, equivalent to more than one-third of the GDP of the EU as a whole.[28] Although this averted massive banking failure and economic disruption, it burdened taxpayers with deteriorating public finances and failed to settle the question.

As the EU crisis unfolded, the absence of Eurozone-wide financial supervisory and resolution mechanisms gave rise to the so-called "doom loop", a vicious circle between the domestic banking system and national governments. In the process, many banks were recognized a systemic role and were thus often bailed out by governments, generally following no coordinated or orderly process. This exacerbated investors' country-risk perceptions – therefore generating higher premiums on national bonds – and worsened deficit problems in troubled countries, some of which eventually necessitated an even bigger bailout (see par 3.3).[29] This also resulted in a re-fragmentation of Eurozone's financial markets, as businesses and households in different euro area countries faced different financing conditions.

As a result, the transfer of national sovereignty that a genuine banking union would represent cannot be underestimated, even while acknowledging that this falls far short from

---

[24] EU Council, "ESM direct bank recapitalization instrument", available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137569.pdf .

[25] The proviso for an emergency voting procedure actually requires only a 85% majority in order to grant financial assistance, but that assistance would come with even more strings attached; cfr. *Treaty establishing the European Stability Mechanism*, Art. 4.4.

[26] D. Thomas, "Euro Member States transfer 3rd tranche paid-in capital to ESM", MNI, 1 May 2013.

[27] B. Rooney, "Europe's stability mechanism remains elusive", CNN, 11 July 2012.

[28] EU Commission, "New crisis management measures to avoid future bank bail-outs", IP/12/570, 6 June 2012.

[29] L. Yueh, "The 'doom loop' between banks and governments", BBC, 21 June 2013.

the EU Commission's proposals on debt mutualisation and Eurobonds (both of which Germany, along with Northern countries, strongly oppose).

At the June 2012 euro area summit, European leaders announced their willingness to transfer key banking policy instruments at EU level. In response, EU institutions set the stage for a fully-functional banking union. On 12 September 2012, the Commission proposed new ECB powers for banking supervision, envisaging the creation of a Single Supervisory Mechanism (SSM) and expressing the wish that the new measures would be approved "by the end of 2012".[30] On that occasion, the Commission described the SSM as one of four pillars for an integrated banking union, the remaining three being the drafting of a single rulebook, the funding of a common deposit guarantee and the institution of a single bank resolution mechanism.

Despite the hopes of the Commission, a pretty long power struggle between the European Parliament and the European Council ensued. This fight reflected both disagreement among different Eurozone countries and a clash between the EU Parliament and the ECB on transparency issues. Many 'virtuous' Eurozone countries, including Germany, did not want the supervisory mechanism to be complemented by a single resolution mechanism, which should have been collectively funded, and preferred to leave bailout responsibilities to national institutions. Meanwhile, the EU Parliament wanted more powers to oversee the ECB's new supervisory role, while the ECB and European Council feared possible leaks to the public of sensitive and confidential information over banks' health.

After a first compromise, reached in March 2013, lots of discussions and disagreement postponed the final approval by the EU Parliament. Finally, on 12 September 2013, exactly one year after the Commission's first proposal, the Parliament approved the SSM. The internal wrangling between EU institutions reflected fears by the Council that Germany wouldn't be prepared to accept much more than a simple supervisory authority, while the EU Parliament seemed eager to speed up decisions over a complete banking union.

Under the SSM provisions, the ECB will be responsible for the supervision of all 6,000 banks of the Eurozone. More precisely, the ECB will directly supervise banks having assets of more than €30 billion or constituting at least 20% of their home country's GDP, as well as those banks which have requested or received direct financial assistance from the EU's backstop facilities. The combined assets of these banks exceed €25 trillion, accounting for 80% of the Eurozone's banking sector. As for the many small banks not fitting this description, the ECB will monitor their supervision by national supervisors.[31] However, the SSM won't come into effect before the ECB has completed a comprehensive asset-quality review of the Eurozone financial system, which was started on November 2013 and is expected to come to an end by October 2014.[32]

As one of the "four pillars" slowly enters into force, progress on the other three has been elusive. As many 'virtuous' countries outright excluded a common deposit guarantee, and considered a single rulebook somewhat as a technicality which could be subsumed under the

[30] EU Commission, "Commission proposes new ECB powers for banking supervision as part of a banking union", IP/12/953, 12 September 2012.
[31] ECB, "Banking supervision", available at http://www.ecb.europa.eu/ssm/html/index.en.html .
[32] ECB, "Note – Comprehensive Assessment", 23 October 2013. For a preliminary list of all the banks that will fall under the ECB's direct supervision, see the Annex of the aforementioned note.

existing powers of the ECB and the European Banking Authority (EBA),[33] attention turned to the development of a Single Resolution Mechanism (SRM). The rationale behind a euro area-wide banking resolution mechanism is well known: if resolution authority remained national, tensions between the SSM evaluating the soundness of banks and the judgment of different national resolution authorities about whether to recapitalize some banks and resolve others could risk short-circuiting the whole system.

The SRM proposal was advanced by the EU Commission in July 2013, with an agreement expected by end-2013 and its implementation by early 2015.[34] The proposal has yet to be voted upon by the Council, where the topic will certainly be hotly debated, and then be tabled by the European Parliament by next April, just before the EU elections.

Under the draft proposal, the SRM would feature a strong central decision-making body and a single resolution fund. The ECB, as the single supervisor, would still be in charge and signal when a bank needed to be resolved. After this initial decision, a Single Resolution Board would be established, comprising the ECB, the EU Commission and the relevant national authorities. The board would issue recommendations on which the EU Commission could act upon, but it would be the Commission alone to decide whether and when to place a bank into resolution. If the Commission opens a resolution procedure, the Board comes back into play to oversee the resolution, which would be implemented by the competent national resolution authorities.

As per the single resolution fund attached to the institutional mechanism of the SRM, the draft proposal envisages a fund solely financed from levies on banks, totaling 1% of insured deposits: over a 10-year period, the Commission estimates that the fund could gather around €55 billion.

Even when coupled with the ESM compromise to constitute a fund to directly recapitalize ailing banks, given the size of the Eurozone banking sector the two mechanisms seem hardly sufficient to serve as a financial backstop in the event of systemic crises. As of today, Germany and "virtuous" countries seem unwilling to agree to anything more than this. The reason is quite obvious: they accept that the SRM cannot come without being endowed of some pool of money that would allow it to reorganize or resolve banks, but they do not want to commit to something that they do not expect will be needed specifically for their financial system, but only for the Eurozone as a whole. They also seem to underestimate analysts' conviction that the Eurozone banking system is so tightly interwoven that many big banks' destinies might depend on other countries' financial health.[35] More recently though, just after the German elections, Merkel's spokesmen seemed more open to the possibility to strike an agreement by end-2013. Key discussions are due in the following months, with the

[33] On 17 July 2013 the CRD IV package (comprising the fourth Capital Requirements Directive and the Capital Requirements Regulation) entered into force, transposing into EU law the new global standards on bank capital known as the Basel III agreement. The new rules will apply from 1 January 2014 to banks in the whole EU28, and are seen as a general preamble for the common rulebook for euro area banks. See Directive 2013/36/EU, on the access of credit institutions and the prudential supervision of credit institutions and investment firms; and Regulation (EU) N. 575/2013, on prudential requirements for credit institutions and investment firms.

[34] EU Commission, "Commission proposes Single Resolution Mechanism for the Banking Union", IP/13/674, 10 July 2013.

[35] A. Thomas, "Germany opposes unrealistic timetable for EU banking union", *Wall Street Journal*, 2 September 2013.

next EU Council meeting on 19-20 December being the most likely candidate for an initial negotiation between Eurozone governments.[36]

3. Conclusions: a politico-economic view

After having critically reviewed the steps taken by EU decision-makers in the past four years and highlighted some of their “holes”, in this concluding section we propose a possible option for the EMU governance to exit today’s stalemate.

The simple, or simplistic, way out seems straightforward enough to many observers: let us uproot the mismatches between economic and political integration, i.e. let us have a European government. Equally clearly, this is not on the European agenda. On the one hand, since well before the crisis, a vast majority of Europeans see the fundamental root of legitimacy as lying with national governments; on the other, reluctance to political integration was exacerbated by the crisis itself, in surplus and deficit countries alike.[37] This is easily explained as fear of expropriation. In fact, a common supranational government seemingly makes for stronger legal hurdles to exit. Hence, surplus countries fear that they could find it harder to leave the coalition in case they are faced with deals they find vexatious; in slightly more technical terms, their outside options are strictly worsened by political integration, which makes them all the more averse to it.

Naturally, one may argue that looser secession clauses can help dampen such worries. This may be a theoretical possibility, but some caution is probably in order. It is difficult to think of realistic exit procedures which does not entail enormous costs for both the seceding country and the rest of the union. In the presence of such costs, the secession threat is not credible, making the clause ineffective.

A far more promising avenue lies in a more careful design of the regulations backing the functioning of the common currency. On this regard, let it be noted that, in the first years of existence of the euro, these rules were typified by the 3% deficit/GDP restriction mentioned above: they were rigid, yes/no criteria, which could only be respected or infringed. As noticed above, this is marred by a dangerous breed of “stupidity”. On the one hand, one could think of plenty of good reasons to break that limit under “exceptional” economic and political circumstances: Germany itself exemplified this fact in 2003-2004. On the other hand, the more punishing a rule, the more it will push towards incompliance and enforcement problems: once again, apparently, the 3% rule was strict only for countries not powerful enough to resist it. Hardly may one think that such a rule can be credible. Nonetheless, one should keep in mind that the need for clarity and objectivity was the main reason behind such rules in the first place.

Therefore, in place of such first-generation criteria, this paper suggests a general shift from the yes-no paradigm to more flexible, but nonetheless automatic, mechanisms based on taxation. An example may help clarify what we have in mind. According to this view, the 3% rule could be replaced by a system attaching immediate penalties to higher deficit/GDP ratios according to a pre-established convexly increasing schedule, possibly mirrored by bonuses if such ratio is kept below a

[36] Reuters, “Germany committed to EU banking union timetable despite post-election coalition search”, 25 September 2013.

[37] See e.g. the results from the Eurobarometer, that show that Euroscepticism (as measured by the sum of respondents that answered to the question “In general, does the European Union conjure up for you a very positive, positive, neutral, fairly negative or very negative image?” with Fairly/Very Negative) in Eurozone countries between 2008 and 2013 increased on average by 14.4% points, and even more so in countries worst hit by the debt crisis; Standard Eurobarometer 70 (Autumn 2008) and 79 (Spring 2013).

certain level. This would act as an incentive to fiscal virtue, without precluding the possibility of recurring to deficit spending in bad times. What's more, it would not give up the character of objectivity of the 3% rule: on the contrary, it would even enhance predictability with respect to it. In fact, the price to pay for increased flexibility should be that, unlike the 3% rule, the mechanism should not be subject to consent from intergovernmental organisms such as the European Council.

The mechanism is much in the spirit of macroprudential tools such as Spain's dynamic provisions of countercyclical capital buffers, as summarized in Caruana (2010) or, to go all the way back, of Keynes' Bretton Woods plan to manage imbalances within the Gold Exchange Standard, to which also Bruni-Papetti's proposal is explicitly indebted.[38] The same may hold true when it comes to EIP and to a third leg which some have suggested to add: a social imbalance procedure.

The idea that taxation works better than regulation is far more general than one might think. It stems from fundamental theoretical results in public choice theory. Suppose the government knows the social externality produced by the behavior of an agent, but it does not know the private cost that the agent bears in adopting a more virtuous behavior. In this case, taxes and incentive mechanisms produce more efficient results than rules. Indeed, imposing an appropriate tax schedule, governments may achieve the first-best allocation, by taxing and redistributing tax proceeds lump-sum to all governments.[39]

This general result suggests that the Union should rely more on (progressive) taxes rather than on (strict) rules. Unfortunately, the reality is different. Probably due to the inability of the Union to have a consistent and independent financial capacity, the use of taxation as a tool to induce virtuous behavior by the members has always been extremely low, in all fields of European integration. Widespread regulation has always been regarded as a viable substitute of taxation, with negative consequences on the efficiency and fairness of policies.

Recently, Alesina and Passarelli showed that, in a political scenario such as the EU, the rules always tend to be overly restrictive when compared to taxes.[40] The reason is that if the decision is made by a vote, the majority is always more likely to choose rules that are too strict than taxes that are too high. In a European context this means that the excessive use of rules results in too strict constraints imposed on the member countries with very high deficits. The authors also show that a majority of "virtuous" countries has a strong incentive to prefer rules over taxes. The reason is that through rules this majority can make the minority bear the full cost of stability improvements. The majority enjoys the benefits without paying anything. This is socially inefficient for two reasons. First, it would be better that the costs were distributed more evenly. Second, the majority tends to choose very harsh regulation, far from the social optimum. This would not be the case with a tax, since the political distortion would be smaller.

The application of these theoretical results to the EMU can provide important insights into the origins of the tensions around EMU governance reforms. Existing tensions have a strong political nature. The high-deficit minority suffers from the decisions of the "virtuous" majority. Rules are

[38] J. Caruana, "Macroprudential Policy: Working Towards a New Consensus", Remarks at the high-level meeting on "The Emerging Framework for Financial Regulation and Monetary Policy", jointly organised by the BIS's Financial Stability Institute and the IMF Institute, Washington D.C., 23 April 2010; F. Bruni, A. Papetti (2013), cit.

[39] As long as lump-sum transfers have the same utility for everybody, the inability of the government to observe individual private costs does not impose any distortions on the economy. All governments have an incentive to reveal their private costs. Technically, this is related to the more general insight that when trying to solve the Mirrlees problem with quasi-linear preferences, truth-telling constraints have no bite.

[40] A. Alesina, F. Passarelli, "Regulation versus Taxation", *Journal of Public Economics*, 2013, forthcoming.

probably and unnecessarily too restrictive. This inefficiency is perceived by the market, in a general context which deteriorates endogenously.

As a result, what types of reforms should be implemented in order to exit the crisis? If one looks at the political distortion, the main insight is the following. An automatic mechanism in which countries reaching high levels of deficit compensate the others through taxation would work much better. Taxation would be incentive-compatible: all countries (even virtuous ones) would lower the deficit to the point where the sacrifice to reduce the deficit further is equal to the sacrifice to pay taxes on the remaining deficit. This, as pointed out earlier, would not only increase efficiency but would also be less subject to political distortions. In a word, more efficiency and probably less tensions around the necessary stabilization process that follows every Eurozone-wide, but also every national, economic crisis. Evidently, this is not intended to be the sole and definitive solution to the crisis, as many other "holes" still need to be managed. But it would make responsabilities and their distribution more even and efficient, thus lowering mistrust and providing a key contribution to the inevitable upgrading of the economic and political integration in the Eurozone. This is the only way to let the single currency work at full speed.