[EU crisis recovery strategies and plans]

(Part II)

In the second part of the research analysis devoted to present crisis in Europe, the strategy steps and numerous plans are discussed taken by both the EU institutions and the member states.

At the beginning of 2008, when the first imprints of the real-estate bubble's crush reached Europe, nobody could predict the enormous negative consequences for economic and financial sector in Europe. The EU bureaucracy, as a rule, follows the "reflective messages" from the member states; the latter could start feeling the crisis only from the mod-2008, at the earliest. Most of the EU member states started feeling "waves of the crisis" only at the end of 2008; there is a general half a year "lag-period" between the "happenings" in the US and their effects in Europe.

The European Commission proposed in May 2010, a new plan to reinforce economic governance in Europe. Europe's economic recovery is seen through strengthening of the functioning of the Stability and Growth Pact and extending surveillance to macro-economic imbalances in the member states. The recent crises and the risk for the stability of the euro area have underlined the interdependence among EU economies and exposed the vulnerability of all its member states, in particular inside the euro area. Fiscal discipline, competitiveness gaps and private sector imbalances are also a matter of concern for the EU-27. These were the reasons behind a new plan for economic policy coordination across the block at the end of May.

The need for "planed coordination". The Commission's approach since January-February 2010 was aimed at aligning the member states' national budget and policy planning mechanisms among the EU-27 through the establishment of so-called «European Semester» in 2010 for economic policy coordination. The EU 27 member states would be involved in the early coordination at the European level as they prepare their national budgets and national reform programmes. In the medium-to-long term, the Commission intends to suggest a permanent crisis resolution mechanism.

The Stability and Growth Pact, SGP as well as the new Lisbon Treaty (2009) establish rules and procedures for sound economic policy coordination among the EU-27; though the coordination was not sufficiently respected. The Commission was of the opinion that control mechanism was not efficient so far; besides, the EU lacked instruments to reduce sufficiently public debt in the member states. The Commission has been warning about the inherent threat for a long time; however, the build-up of macroeconomic imbalances was not appropriately addressed. In a number of member states, this translated into high current account deficits, large external indebtedness and high public debt levels, which are clearly above the 60% reference value set in the Treaty. Hence, the financial stability of the euro-zone as a whole has been put at risk (1).

Tough economic decisions in early 2010. Eurogroup ministers, together with the ECB Governor Jean-Claude Trichet, Olli Rehn, Commissioner for Economic and Monetary Affairs and other EU Economic/Finance Ministers at their meeting in Brussels (6.02.2010) discussed regional economic situation and the latest developments in financial markets. The EU Ministers exchanged views on economic, financial and fiscal situation in Greece – in January 2010 the Greek government submitted the update of the stability programme to the Commission and the Council (2).

The programme envisages reducing the general government budget deficit by 4 percentage points to 8,7 per cent of GDP in 2010, and correcting the excessive deficit in 2012. The programme contains a package of concrete fiscal consolidation measures for 2010, providing also the estimated quantification of each one of the measures included, as well as the timeframe of their adoption and implementation. In addition, it includes the broad lines of a number of structural reforms aimed at improving the budgetary framework and the efficiency of public spending, enhancing investment and improving the functioning of labour and product markets.

EU surveillance mechanism. In view of the public finances deterioration in Greece and the external imbalances, the Commission – for the first time – applied an integrated approach to the national crisis using the enhanced surveillance mechanism. Therefore, the Commission recommended to the Council to adopt the following steps:

- Adoption of the Greek Stability Programme for 2010-2013;

- Taking a Decision following Art. 126(9), TFEU on the correction of the excessive deficit; and

- Making a Recommendation under Art. 121(4), TFEU on structural reforms.

The Commission recommends to the Council, under Art 121, TFEU that Greece adopt a comprehensive structural reform package with the following priorities:

- increasing the effectiveness of the public administration,

- stepping up pension and healthcare reform,

- improving labour market functioning and the effectiveness of the wage bargaining system,

- enhancing product market functioning and the business environment, and

- maintaining banking and financial sector stability.

Under the Commission recommendation for a Council decision (according to art. 126, p.9, TFEU), Greece is required to follow the adjustment path outlined in the 2010 stability programme in terms of nominal deficit, structural deficit and change in debt levels, as well as detailed measures for implementation. The recommendations include measures for 2010, whereby Greece should, as announced in the programme, stand ready to adopt additional measures to ensure that the adjustment path is followed. In the medium term, Greece is required to implement further adjustment measures of a permanent nature, continue with tax administration reforms and improve the budgetary framework.

Continued monitoring. The Commission promised to continue monitoring the situation in Greece, in close contact with the President of the Eurogroup. Greece was required to submit a first report in mid March 2010, spelling out the implementation calendar of the measures to achieve the 2010 budgetary targets, standing also ready to adopt additional measures if needed.

Following up a first orientation debate on the subject in January, the Eurogroup has had a discussion on the surveillance of competitiveness developments and imbalances within the euro area. In its report on the first 10 years of Economic and Monetary Union, the Commission concluded that macroeconomic surveillance needed to be broadened to include divergences in competitiveness and imbalances and the Eurogroup members endorsed this view (3).

Implementation of the Stability and Growth Pact. As the economic and financial crisis takes its toll, the implementation of the Stability and Growth Pact (SGP) is guiding Member States to ensure that the budgetary impact is reversed, that excessive deficits are corrected and that fiscal policies are specified and subsequently implemented to achieve long-term fiscal sustainability.

The SGP possesses the necessary flexibility to deal with current exceptional circumstances, while maintaining focus on the consolidation needed to prepare for the budgetary impact of ageing as well as the structural reforms required to enhance stability and growth potential.

EDP particularly steps for Hungary, Latvia, Lithuania, Malta, Poland and Romania.

The EU made efforts to restructure prudential standards for "systematically important institutions", i.e. most vital banks. The member states' ministers reviewed the discussions on the regulation and the supervision of "Systemically Important Financial Institutions", in the context of a) G-20 roadmap on the reform of financial regulation; b) the work of the Financial Stability Board, the Basel Committee on Banking Supervision at international level, the European Commission and the Economic and Financial Committee; and c) recent proposals of the US administration on financial control (4).

Stronger governance. The Commission proposal in early 2010 was aimed at establishing stronger economic governance among the EU-27, i.e. to reinforce compliance with the rules and principles set out in the Lisbon Treaty and the SGP (especially for the euro-zone states) and to establish formal procedures to deal with macroeconomic imbalances that can jeopardize the functioning of the economic and monetary union (EMU).

However, the problem was not the one for the euro-zone states only; the economic interdependence touches upon all EU members states, the economy of which are strongly interlinked through the single market. More than 60 per cent of block's trade occurs within the EU-27 market including cross-border trade and financial spillovers in the banking sector.

The Lisbon Treaty provides numerous facilities for progress through a better and full use of the existing economic policy instruments, and through revised and new EU legislation. In particular, the TFEU's provisions on economic policy coordination enable the Union to develop new tools for reinforced economic governance in the euro-zone (art. 136, TFEU).

The Commission's approach to recovering from the crisis is based on three pillars:

- reinforcing the Stability and Growth Pact's criteria;
- addressing macro-economic imbalances and divergences in competitiveness among the EU-27, and
- working towards a permanent and robust framework for crisis management.

During the so-called European Semester, the member states would benefit from early coordination at the European level, when they prepare their national budgets and national reform programs. There is a difference between the surveillance for the EU as a whole and for the euro area specifically. The integrated surveillance cycle through the European Semester applies to all EU member states; as to the euro-zone, the Commission proposes to go further by including surveillance of macroeconomic and competitiveness developments, complementing the fiscal surveillance for all EU member states. Besides, the Greek sovereign debt crisis has also showed that a robust framework for crisis management for euro-zone is needed..

The Commission will seek the views of the member states and the European Parliament, and will bring forward legislative proposals at the end of 2010 and early 2011.

Fiscal discipline. The Commission has underlined that the member states have not done enough in good times to reduce their public debt over the past decade. Furthermore, in some member states' budgets were built on the assumption that the additional revenues received during the boom were to be considered structural improvements in the underlying position rather than temporary additions due to exceptional conditions.

During the crisis the deficits – both GDP and public – went up: they are expected to exceed 7% on average in Europe in 2010. On unchanged policies, debt ratios are projected to reach 84% in EU (88% for the euro-zone) in 2011. Large public debt weighs on economic growth and on a government's ability to run counter-cyclical policies when needed.

The Commission's proposals for fiscal discipline include:

- to reinforce preventive budgetary surveillance in order to allow early detection and early action. This surveillance takes place mainly through the assessment of Stability and Convergence Programmes. This is the core of the preventive arm of the Stability and Growth Pact.
- for early detection, the Commission proposes an early peer review at EU level of the broad budgetary guidelines of each member state, thus informing their competent authorities of the European perspective and guidance before they adopt the national budgets. The approval of the Commission's proposals to reinforce Eurostat's mandate to audit national statistics is a prerequisite to ensure that the assessment is based on accurate data.
- the Commission proposes, for early actions, the possibility of imposing interest-bearing deposits on those member states which make insufficient progress to their Medium-Term-Objectives in good economic times, because of inadequate fiscal policies.
- as part of the strengthened preventive action, the Commission also encourages member states to integrate in their national law the Lisbon Treaty obligations on budgetary discipline (See Protocol Nr.12, TFUE), putting in place budgetary procedures that ensure compliance through legally binding instruments.
- when a member state goes off track, the corrective part of the Stability and Growth Pact kicks in through the Excessive Deficit Procedure (EDP). The EDP needs strengthening through, e.g. speeding up procedures, in particular for those in repeated breach; for instance, the initial steps of the procedure could be skipped for countries in repeated breach.
- more attention will be given to the debt criterion: member states with debt ratios above 60% of GDP should become subject to the EDP if the decline of debt in a given period falls short of an appropriate benchmark (see art. 126, TFUE).
- broader and more timely use of the EU budget to ensure compliance with the SGP should be considered.
- suspension of the Cohesion Fund is foreseen at a late stage in the EDP (according to art. 126, 8, TFUE).

- the Commission argued, that under the new Financial Perspectives for the EU budget, the establishment of fair, timely and effective incentives for compliance should be established. E.g., once the existence of an Excessive Deficit is established (art.126-6, TFUE), member states could be asked to redirect funds to improve the quality of their public finances, in particular reducing transfers and public consumption to favour investment.
- the EU's Cohesion policy could play a greater role, for instance by strengthening institutional capacity and efficiency of public administrations. The EU 5 th Cohesion Report will present corresponding proposals. In this regard, a more rigorous application of the existing suspension clause for Cohesion Fund commitments should be pursued in case of SGP's current violations (5).

It is notable, that the Council Regulation (EC) No 1084/2006 specifies that the "suspension clause" can be explored in the following cases (art. 4,a): "If the Council has decided in accordance with Article 104(6) of the Treaty, that: a) excessive government deficit exists in a beneficiary Member State, and if it has established in accordance with Article 104(8) of the Treaty; that b) the Member State concerned has not taken effective action in response to a Council recommendation made under Article 104(7) of the Treaty". In this occasion, the Council may decide to suspend either the totality or part of the commitments from the Cohesion Fund for the member sate concerned with effect from 1 January of the year following the decision to suspend.

The peer review by the Commission would fully respect the prerogatives of the member states and national parliaments' decisions. That would safeguard the EU governance and national sovereignty. On another hand, it would provide information and guidance for the preparation of the national budgets in the following year. These steps are about informing the Commission and ensuring that national budgets are consistent with the European "economic dimension", so that the stability of other EU member states are not at risk. Those member states, which follow the SGP rules and implement the EU budgetary discipline, can be regarded as examples for other EU partners. They can share their experience with others in the peer review, and thus contributing to safeguard the Union's financial stability.

The competitiveness and macroeconomic imbalances. The accumulation of large and persistent imbalances among euro-area member states potentially undermines the cohesion of the euro area and hampers the functioning of EMU. During the first decade of the euro, the euro area has seen steady divergence in the current account and competitiveness positions of its member states. Some euro-zone countries have accumulated large current account deficits and experienced large losses in competitiveness. These trends were associated with a misallocation of capital and labour, unsustainable accumulation of debt and housing bubbles. Other Member States accumulated large current account surpluses reflecting persistent weakness in private sector demand.

The Commission proposes a broader economic surveillance framework for the euro-zone states. This surveillance should go beyond the budgetary dimension to address also other macro-economic imbalances such as competitiveness developments and underlying structural challenges. Taking into account deep economic and financial interdependence within the euro area and their impact on the single currency, the Commission, in its EU-2020 strategy, called for the development of a specific policy framework for the euro-zone to tackle broader macroeconomic imbalances. The European Council subsequently asked the Commission to present proposals for strengthening coordination within the euro-zone states. Depending on the situation of the member state concerned, the recommendations could address the functioning of labour, product and services markets, in line with the Broad Economic Policy and Employment Guidelines. They could also cover macro-prudential aspects to prevent or curb excessive credit growth or excessive asset price development, in line with the future European Systemic Risk Board analysis.

The European Semester: 2010. The Commission proposed in its EU-2020 strategy to do the assessment of the structural and fiscal policies of member states in parallel. The European Semester's idea was to establish an integrated surveillance cycle, allowing such synchronized assessment to take place in an efficient and effective manner.

The process would be as follows:

- It would start in 2010 with a horizontal review under which the European Council, based on input from the Commission, would discuss the main economic challenges for the EU and the euro area in view of giving strategic guidance.
- The results of this discussion would be taken into account by member states when preparing their Stability and Convergence Programs (SCP) and their National Reform Programs (NRP). The EU-27 member states are encouraged to involve their national parliaments in full respect with national rules and procedures before submission to the Commission.
- The SCP and NRP would be issued simultaneously. This means submission of the SCP should take place in the first half of the year instead of towards the end of the year.
- The Council, based on the Commission's assessment, would subsequently provide assessment and guidance, at a time when budgetary decisions are still in a preparatory phase at national level.

The results of such ex-ante budgetary and economic surveillance at the EU level would allow the competent national authorities to be informed of the European perspective and guidance, enabling them to take more informed decisions under their national rules and procedures.

EU's framework for crisis management. Recent events in the developing of the crisis have shown that:

- the financial distress can threaten the macroeconomic stability of the euro-zone and the whole EU-27 alike;
- the best part of a crisis mechanism is fiscal discipline, as well as tackling imbalances before they occur, i.e. providing the optimal predictions;
- however, if the crisis returns, corrective actions are needed to avoid the negative implications;
- in case the corrective actions are not enough, additional measures shall be implemented. Thus, building on the temporary European stabilization mechanism approved by the ECOFIN meeting on 9 May 2010, the Commission intends in 2011 to suggest the creation of a permanent crisis resolution mechanism, which will be accompanied by a detailed and demanding programme of the EU economic policy coordination.

European rescue plan: loans and guarantees. For the first time since the European member states have been involved in measures to tackle the financial crisis in late 2007, the EU agreed on a gigantic package of loans and guarantees in mid-2010. European and global business and market managers have long been trying to find a consolidated answer to the EU-27 ability (mostly that of the eurozone's countries) to honour their financial obligations. Traders generally were skeptical of the eurozone group to find common ground and political will to assist EU's southern neighbours out of the crisis: “for the first time since the onslaught of the financial crisis, the EU leaders were one step ahead of markets, rather than trailing behind them” (6).

After extensive negotiations between the EU-27 finance ministers, heads of the national central banks and IMF’s representatives, a new rescue plan was finally adopted. The agreement was actually about a “rescue package” consisting of loans and guarantees of about € 750 bln (about a trillion US dollars, i.e. 936 bln on the then rate of exchange at that time). The final declaration about the package was announced at the World Economic Forum for Europe (10-11 May, 2010).

Three main components. The agreed loan and guarantee package consists of the European efforts (of € 500 bln) and the IMF assistance of € 250 bln. However, the whole “package” can be assessed on three rescue directions:

- First, with a **€ 500 bln package of loans and guarantees** for the next 3 years. the EU leaders pushed new impetus into the eurozone rulebook;
- Second, **greater austerity measures** are expected in both the eurozone states and other EU members, and
- Third, the **European Central Bank has agreed on various financial security instruments** to assist the “package” implementation and buy governments’ sovereign bonds to address security issues.

In addition, all European Union governments are backing a € 60 bln extension of an existing balance-of-payments facility that has so far benefited non-euro countries – Hungary, Latvia, and Romania. That means that this “specific facility” will be increased to € 110 bln (7).

Hard choice. It is not for the first time that the European economic and financial integration faced hard times: e.g., the EU’s exchange rate mechanism was threatened already in 1992-93 and was rescued by widening the currency fluctuation limits. In order to avoid such incidents, the decision was reached to introduce euro in 1999. The history of European integration has been sometimes under very strong pressures; however the governments made some hard choices at the right moment. The EU member states were deemed to act in accord in order to escape from a major blow to the euro; this was the main reason behind the EU governments’ acceptance of the rescue plan.

The € 750 bln plan’s success will rest largely on the ability of the EU-27 governments to persuade citizens that painful austerity programmes and economic reforms are both the price for the eurozone membership and the safest long-term guarantee of prosperity. At the heart of the plan is a compromise under which financial aid will be extended to the EU “problematic countries” under conditions that they undertake rigorous efforts to restore fiscal discipline.

The Commission intends to strengthen mutual surveillance of eurozone national budgets in order to address a growing European problem, i.e. the widening gap in competitiveness between Germany, France and the UK and countries with low productivity such as Greece, Italy, Portugal and Spain. This proposal is based on an idea of a “grand bargain” under which France, Germany and others would accept the single market’s expansion in the services sector, energy and the digital economy, while the UK and its allies would accept a greater degree of tax policy co-operation. The implementation will depend on whether the EU-27 governments would approve the Commission’s recommendations at the end of 2010.

Economic problems. The roots of the first critical economic recession in Europe and its monetary union being the worst in 80 years lie in the unresolved differences between France and Germany over how to manage a monetary union of which they were the main partners from the start. The outcome was a created toxic mismatch of high debt and slow growth that hampered growth in Europe's southern states (8).

The Commission's measures in 2009-10 in reinforcing the European integration have consisted of two main elements. **The first**, a joint guarantee by eurozone governments for a special "rescue fund" of € 440bn for liquidity loans (in 2010); the one that been offered to Greece. This "guarantee fund" supplemented the International Monetary Fund with the strict IMF-set conditions attached. With the accumulated financial support of € 750bn, the EU intends to escape the crisis' spreading to other member states and inspire the markets.

The second step was the European Central Bank's decision to buy governments sovereign bonds "to address malfunctioning securities markets", the step aimed at reducing pressure from eurozone states and tolerate bond markets.

Both measures show the EU's determination to reduce crisis' negative effects, rather than to eliminate its causes; however, these measures raised the economic and political risks to new heights.

The fact was that economic dangers did not disappear overnight: loans and guarantees could reduce the immediate risks to sovereign funds, but not for long. Some say that the total gross borrowing needs by eurozone countries exceed € 1,000 bln in 2010. Besides, the liquidity does not equal solvency: buying vulnerable states time to rein in shaky finances does not automatically cut deficits nor stabilise debts, argued the FT's European correspondent in Brussels (9).

The economic problems are deeply rooted in moral hazard for sovereign borrowers and in the banking sector. Experts are of the opinion that unless the "financial industry" is radically reformed, the taxpayers will be hesitant to be involved in the rescue. As to the political connection, there is a real danger that a euro member's failure to pay its debts will increase instability in other ECB's members and incur losses that can only be covered by fiscal transfers or money printing. Strict surveillance and ECB independence, according to the Stability and Growth Pact, was meant to make the worst impossible to happen; unfortunately, both requirements have been undermined, as T. Barber argued. The EU's idea of "pooling more sovereignty" must be balanced against the member states' ability to take responsible sovereign decisions for sustainable economic policies.

The common currency rules have been always ill designed, practically and in terms of growth and stability. Hence, the Commission intends to reduce risk-taking: the conditions for loans and guarantees must be made clearer, so that a government that is truly unable or unwilling to pay must be traced in advance.

Capitalism's future as an economic system: German's view. The current crisis is apparently sweeping aside many established ideas of how societies should run their economies. In Germany, the crisis has both shown the worst recession in postwar history and pictured the end of the financial system as is commonly known. The US way to approach crisis has shown (in the era of Alan Greenspan, former US Federal Reserve chairman) the appearance of a new economic paradigm.

Some have called for the renaissance of state-monopoly capitalism, labeled “new capitalism”.

German economics minister argued that the crisis could change drastically the financial sector, with enormous risks for society. He said that “we already have the conceptual approach we need to set up intelligent rules to which all market actors have to adhere and that will foster transparency, credibility and trust. We know how to pursue stability-orientated monetary policies. We need to revive a *culture of stability and responsibility in business.* Individual incentives should reward long-term success, prevent short-term excesses and punish inordinate risk-taking” (10).

The minister pointed out that in sticking to rules on competition, state aid and trade social systems should shield market participants from the market negative consequences, though not at the expense of market flexibility. These principles are the leitmotifs of the social market economy model on which both the EU economic structures are built and Germany’s economic development, in particular.

It is imperative that in both short-term crisis management and long-term decisions the policymakers, bankers, investors and voters **understand clearly what went wrong with the European and world economy,** argued German minister. Some elements of the build-up of the housing and financial bubbles have been clearly seen long ago: e.g. loose monetary policy; the wrong kind of incentive in the housing markets; a lack of regulation of financial institutions, which allowed the creation of a shadow banking system; inadequate incentive and risk-management systems within banks; and a failure of rating agencies and of financial market supervision.

Some have also referred to the bankers’ breathless search for profits, the euphoria of a new, “risk-free” financial world and lack of understanding of the new financial instruments. Preventing a recurrence of the serious systemic risks that arise from these inherently human phenomena requires rules that –in order to be effective- set strong and clear incentives.

Coherent approach. The EU tried to focus on measures that enhance long-term growth and maintain fiscal responsibility. The German **stimulus packages** – the biggest in the European Union – have thus combined additional government spending on infrastructure with reductions in taxes and social security contributions. At the same time, the federal government has agreed to a tightening of its deficit rule, enshrined in the constitution, in order to guarantee the long-term sustainability of public finances.

In the mentioned measures, the EU wanted to avoid that the crisis would be a cover-up for ad-hoc **protectionism and interventionism.** Therefore, all stimulus measures at the national level should be at least non-discriminatory and rule based. Thus, **European competition rules** as an integral part of the European economic integration have served EU and the member states well for the 50 years. It is now all the more important to strike the right balance between sticking to the rules and necessary flexibility. Intervention as a last resort on the basis of systemic risk and public control must be restricted to the financial sector. Since the governments usually lacks the necessary expertise and personnel to run companies on a large scale, **policymakers should work on exit strategies** before intervening.

Boom-and-bust cycles are inherent in market economies and cannot be prevented completely, argued the German economy minister. EU governments now need to work **on reducing systemic**

risk in the financial sector without unnecessarily restraining financial innovation. One way would be to take account of the global economic dimension of the crisis hitting the financial sector. The other way is to reform rules and establish new ones for the sector.

The German minister undrlined **three principles** which should guide the financial recovery, in the first place:

- **first**, risk management within banks and risk supervision by rating agencies and financial authorities must be strengthened on a global level to prevent the build-up of systemic risk;
- **second**, to prevent an increase in moral hazard there must be a blueprint for the treatment of failing systemically relevant banks that ensures that it is the management and shareholders who are held most accountable;
- **third**, rules made in future must attempt to cover all systemic actors in the financial sector and to avoid regulatory gaps.

Economic crises usually polarise the political debate. Using taxpayers' money to save financial institutions whose bankers receive bonuses while letting victims of the crisis fail in the real economy will be challenging for politicians to explain. Explaining economic policy, finding credible long-term solutions and providing equal economic opportunities for citizens are preconditions for a good future for market economies in all four economic models in Europe, including the continental European and Anglo-Saxon versions (11).

European stabilisation machanisms: national problems. The present crisis has two sides – the economic and the financial: the former hit almost all European states, the latter – mostly the euro-zone countries. Over the past decade, the euro-zone has facilitated one of the largest moral hazard schemes of all time; until mid-May 2010, this operated at two levels.

Spain and Ireland built huge banking systems, drawn into a property bubble – but really based on the rules of the eurozone, which implicitly underwrite its commercial banks without adequate supervision.

Portugal and Greece ran old-fashioned out-of-control fiscal deficits, financed by bank lending – with all the debt available to use as collateral for short-term borrowing ("repo") at the European Central Bank; and underwritten by implicit too-big-to-fail guarantees, which became explicit in May 2010.

The Italians fall into a less extreme category, but they are also in the line of fire due to a mix of imprudent banking and wishful budget thinking (12).

European banks, too, were happy to participate in this policy delusion: numerous government decisions were "almost no capital required" and "freely available to use for repo" at the ECB. On top of all this, the eurozone leaders threw everything they had in liquidity terms at the problem, with the US approval, the International Monetary Fund's rescue too. The market applauded initially, but then it started to calculate on the underlying fiscal solvency.

Greece has become a complete fiscal disaster. Under the new IMF programme, Greece needs to eliminate its debt problem soon. Greece's debt/gross domestic product ratio will be 145 per cent of GDP at the end of 2011. Using more realistic growth figures – e.g., with GDP down 12 per cent to the end of 2011 – then the debt/GDP ratio may hit 155 per cent. At that level, with a 5 per cent real interest rate and no growth, it needs a mind-boggling primary surplus of 8 per cent of GDP to keep the debt/GDP ratio stable.

Portugal is almost as bad. Just to keep its debt stock constant and pay interest on its debt at an optimistic 5 per cent, it needs to run a primary surplus of 5.4 per cent of GDP by 2012. With a planned primary deficit of 5 per cent of GDP this year, it needs roughly 10 per cent of GDP in fiscal tightening. It is near-impossible to do this in a fixed exchange rate regime without massive unemployment.

Ireland is held up as a model to suggest that this is feasible – but despite their austerity, even the perpetually optimistic European Commission thinks the Irish budget deficit will be close to 11.7 per cent of GDP in 2010 and 12 per cent in 2011. Former "miracle in global growth", so-called Celtic tiger, it is expected to knock on the door of the European Stabilisation Mechanism. In fact, the situation has become worse in November 2010, when Ireland started working with IMF and ECB to find a solution to country's debt-laden banking system. The problematic banking sector is closely connected to other spheres in country's development, mainly construction "bubble". (13).

Hungary and Latvian situation is different; the countries were offered loans in size of 11,5 and 7,5 bln euros. However, on the list of top 10 EU banks a year ago was one Hungarian (OTP Bank) with 13,8% tier one capital ratio at the end of 2009 and 16,2% at the end of 2011 (expected).

Risks. The EU governments have the greatest incentive to default when they are running a balanced primary budget (i.e., after substantial budget cuts) and still have large government debt outstanding. The incentive structure means they will postpone a decision to default that would otherwise be rational now. Given the incentive problems in the eurozone, it is no wonder more nations want to join – the requirement is just to appear prudent for a few years. Nations with profligate governments or weak financial systems have a bonanza; overall, this system encourages a "race to the bottom" – led by governments in smaller countries, which relax fiscal and credit standards to win re-election (or just to enjoy a boom). They borrowed funds from the (unnaturally) less profligate in the eurozone. The Germans were austere; the periphery enjoyed the boom. Now we have moved past the boom, and someone in Greece, Portugal, Spain, Ireland and perhaps Italy has to repay something – or at least stop borrowing without constraint.

External financial support only makes sense if combined with reforms to eurozone incentives. Recent decisions jammed open the ECB credit window and send a clear message to creditors: you can again lend to the profligate without risk. Such emergency measures actually further undermine any government's willingness to address its solvency issues.

This can now go two ways: eurozone countries cede substantial sovereignty over fiscal policy (such as over budget deficits) and create a single strong bank regulator; or they let a system persist that creates another global "doomsday machine", perpetuating boom-bust-bailout cycles. In the first scenario, countries such as Greece eventually default. In the second, Europe further accumulates interconnected debt – until the eurozone more broadly "defaults", either through repudiation or inflation.

Most of the EU member states are living beyond its means, argued European economists.

Government deficits are out of control and public-sector debt is rising. Greece’s financial crisis was an extreme example of a broader EU problem. Investors have been looking nervously at debt-levels and budget deficits in Spain, Portugal and Ireland for months. But even Europe’s big four – Britain, France, Italy and Germany – are hardly immune from these problems. Thus, Italy’s public debt is about 115 per cent of GDP; some 20 per cent of this needs to be rolled over during the course of 2010. Britain is currently running a budget-deficit of nearly 12 per cent of GDP, one of the largest in Europe. George Osborne, the new UK’s Chancellor of the Exchequer described Britain’s official economic forecasts as a “ work of fiction ”. The French government has not produced a balanced budget for more than 30 years. And one of the reasons for the deep bitterness in Germany at bailing out Greece, is the knowledge that Germany is already struggling to balance its own problems.

Citizens of Latvia and Ireland have already swallowed actual cuts in wages and pensions. But these are both countries that have experienced real poverty in living memory, followed by massive and unsustainable booms; the last years have been terrible for these states (14).

R iots on the streets in Greece and other EU capitals illustrate, that not all Europeans will react peacefully to deep cuts in spending. Many have come to regard early retirement, free public healthcare and generous unemployment benefits, as fundamental rights. Strange enough, they stopped asking, a long time ago, how these things were paid for. It is this sense of entitlement that makes reform so difficult. As the recent elections in some EU states have illustrated, politicians are extremely reluctant to confront voters with the harsh choices that need to be made.

The EU leaders are of the opinion that if Europeans do not accept austerity now, they will eventually face something far more shocking – sovereign debt-defaults and collapsing banks.

European unity. The growth in the size and power of the EU has produced among people a dangerous sense of complacency. For the countries of southern and central Europe – who joined later than the inner core – the “Brussels-center” was regarded as the ultimate insurance policy. Once they were inside the EU, it was felt that conflicts, dictatorship and poverty were all in the past. Everybody could aspire to the relatively comfortable, stable lives and for many years, it worked beautifully: living standards were increasingly climbing up…

In recent years, **European unity** has also been marketed as an insurance policy for the EU members, e.g. both President Sarkozy of France and Angela Merkel, the German chancellor, speak of a Europe that “protects”. The idea was that the EU with 27 nations was large enough to protect a unique European social model from the uncertainties of globalisation.

At the most fundamental level, the EU does indeed protect its members; Europeans no longer fear foreign invasions, through they start fearing foreign investors as Europe’s future and “specific lifestyle” has depended on the supply of credits.

The recent bailout essentially extends one massive credit-line to those European governments that really need it. But, it is felt presently that the social costs of these credit-lines will produce a sharp increase in political tensions within the EU. For example, in Greece there is much talk about the loss of national sovereignty, while in Germany – bitter talk about the costs of bailing out feckless southern Europeans.

Another “truth” that Europeans have discovered was that the “European project” provides no protection against the harshness of the outside world. Unless the EU makes right steps in rights direction, things can still go badly wrong.

Historic decision: rescue plan for euro-zone. At the EU's eurozone summits in May and September 2010, the Commission's president formulated main aspects of the important package for the stability of the euro-zone currency. The Commission reassured its members that the EU will do whatever is necessary to defend the stability of euro, the EU common currency.

The Commission's steps are based on the proposal to create a mechanism to assist euro-area member states with loans guaranteed by the EU budget. In addition, it provides assistance guaranteed by participating Member States.

The total amount of approximately € 500 bln is unprecedented in its scale and should be seen in conjunction with the measures taken by the ECB and the IMF. There is the commitment of the IMF to come to a participation of around half of what the EU member states agreed to contribute; this agreement will ensure that any attempt to weaken the stability of euro will fail.

The decision has shown the determination of the whole EU to stand behind any of its member states when they are seriously threatened with severe difficulties caused by exceptional circumstances beyond their control. The decision, however, is not only about assistance, it is also about further efforts of fiscal consolidation and of a combination of budgetary efforts by countries under pressure and assistance by the others as a "consolidation pact" for the euro-zone states.

Perspective Commission's actions. The Commission has long been making efforts for reinforced EU's economic governance: for many years, the EU leaders postulated adequate measures to coordinate the monetary union with closer economic development in coordinated Europe. The Commission is working on reinforcing both the economic governance and the compliance with the Stability and Growth Pact. The idea is to broaden surveillance of macroeconomic imbalances and reinforce regional competitiveness in view of a permanent crisis management mechanism in accordance with the Lisbon Treaty. The treaty's chapter on exceptional circumstances in economic development allows "the Union financial assistance to the member states" (art. 122, TFEU).

The Commission's president acknowledged the need for a "stronger union in economic policy", a stronger compliance by the member states with policies and rules agreed at the Union level.

The Commission underlines that the main lesson from the crisis is that creation of a monetary union leads to the promotion of an economic union. This does not mean making every member state exactly the same at the same time but it certainly means reinforced economic governance and respect of all the obligations member states have under the Stability and Growth Pact.

On the informal level, the Commission invited representatives of European employers and trades unions for discussions on economic crisis' consequences and possible employment actions as the European Commission continued during 2009-10 to implement the **European Economic Recovery Plan.** A wide consensus was shown for the Recovery Plan providing the right springboard for tackling the crisis and taking action on jobs in Europe. Already in February 2009, the Commission and the European social partners (ETUC, Business Europe, CEEP and UEAPME) agreed on the need to work together to safeguard and develop further the social and economic achievements of the EU and its internal market as the source of prosperity, growth and jobs in Europe. The European

Economic Recovery Plan proposed by the Commission and adopted by the European Council in December 2008 sets out a wide range of measures to keep and create jobs and maximise the ability of the European economy to get through the recession. Many of the key elements in the EU Recovery Plan will have a direct impact on the workforce. These include training to keep people in work and to help them find new jobs. EU funding is available through the European Social Fund and the European Globalisation Adjustment Fund; new sources of finance are available for SMEs.

The EU new economic order: managing Europe's downturn. The European Union has been focusing too much on the monetary part in the economic and monetary union issues neglecting generally its economic part. The EU presently needs agreed stimulus to push towards economic union by means of a deeper and more integrated single market. This is a modern vision of a Union's new economic order.

Since the first waves of economic and financial crisis, the EDU has experienced several vicissitudes. Bottom-line: the EU-27 member states managed to keep afloat, so far. Even Greece's tragedy did not – in general – tarnish the positive steps stretching ahead.

The EU-27 national leaders often conduct debates among themselves by shouting across their borders with an eye on domestic electorates; "then they all come together and compromise in the name of European solidarity" (15).

Something like this happened for example with Greece. After weeks of debates as how to help the economy in crisis, the EU's leaders at a summit at the end of March agreed on a common package of financial assistance, though with the participation of the International Monetary Fund. Noteworthy, the EU-27 leaders committed themselves, at the same time, to closer economic governance and promised more intrusive oversight of national economies as a condition for positive "governance".

It is interesting to see expert opinion from "outside the EU headquarters". As is well known, former EU Commissioner Mario Monti, was asked by the European Commission to recommend ways of relaunching the EU's single market. He argued that the Greek crisis has thrown up an opportunity for the eurozone states to redesign its one-sided economic structures. The European Central Bank may have provided a single monetary policy for the eurozone, he argued, but enormous differences remain as to how its 16 national economies would operate further on.

A more efficient use of resources across all 27 EU countries could significantly improve the economy's productivity and employment levels, he suggests. "We have focused on the monetary part of economic and monetary union while neglecting the economic part," says Mr. Monti. "What is now necessary is a further push towards economic union by means of a deeper and more integrated single market" (16). Henry Kissinger once said that one does not design a new world order as an emergency measure; however, emergency can bring about a new world order. It might prove right with a new European economic order.

Politics and economy. The scale of the political challenges laying ahead the EU leaders, no matter how strong the economic logic of closer integration may be, has a priority in approaches. Most of the EU problems are economic in essence, e.g. 27 mln unemployed people and runaway public finances, the necessity of structural reforms (whenever painful) and the needed to raise Europe's longer-term growth potential, particularly negative effect of the global financial crisis on the EU "social market economy model", these and other challenges politicians in the EU-27 will struggle to press ahead with.

Usually, the EU leaders did not face problems in agreeing upon ambitious goals; however, creating and implementing instruments to realise them was much more complicated. The EU-2020 Strategy envisages that more peer pressure can be applied to recalcitrant countries.

The new Lisbon Treaty has fixed peculiar "competence divisions" among the EU institutions and the member states with a view that national politicians will react adequately to advises from Brussels. The single market is the main achievement of the more than half a century of European integration. Paradoxically enough, those EU members outside the eurozone (e.g. the UK, Sweden, Denmark, and the newer EU members) are the most enthusiastic supporters of the single market. It is quite apparent at present that two countries – France and Germany – are going to drive the process within the 16-eurozone countries.

New economic order. The Lisbon Treaty has shown that after fulfilling the main economic targets of European integration, another Union's strategy appeared heading towards deeper political integration. This assertion made two main changes: first, it changed the essence of "integration" turning it into close cooperation and coordination; second, the main background of the EU as a federation structure turned into confederation.

In the present form, the EU – most probably – will not survive another half a century; some drastic measures and actions are needed to combine divergent member states' expectations and making common efforts to confront the global challenges.

Hence, the new economic order in the EU is a necessity, which cannot be ignored anymore.

European Financial Stabilisation Mechanism would operate as was envisaged in the EU rescue strategy since 2013 as a loan guarantee mechanism, which has no direct links with the EU budget. Loans could be guaranteed up to € 60 bln from a special EU stabilization fund. The EU budget would be involved in the unlikely case of a default on a reimbursement. Even if the EFSM is activated in 2011, a first reimbursement would not be due before 2013 (depending on the reimbursement schedule).

Recent approaches in rescuing the EU and euro. After numerous attempts to save the Union's economy and, in particular, the common currency – euro, the EU leaders at the end of 2010 started to think differently. Two new approaches have appeared after December 2010 summit and finance ministers' meeting in Brussels.

Although the meeting of EU finance ministers in Brussels (6-7 December, behind closed doors) ended without evident signs of consensus on further Union's steps to resolve the crisis, two main ideas appeared after tense discussions: a) increasing the size of already established EU rescue fund (€ 440 bln), and b) creating a European-wide bond market.

However, neither the EU officials nor the member states managed to reach agreement on the urgently needed further steps.

In fact, the options on the table for the EU finance ministers were really quite limited: some focused on bond-buying sovereign debts by the ECB, others on increasing existing EU rescue fund facilities; some new ideas have been in waiting. Apart from the decision to bailout Greece and Ireland, the ministers have relied on significant bond purchase by the ECB to reduce borrowing costs for two other EU risk economies, i.e. Portugal and Spain. This move is expected to save, in particular, the euro-zone members' diverging creditworthiness.

So far the following two options seem worth mentioning:

1. The first option was clear and simple enough: to increase the EU's rescue fund (presently at € 440 bn). Klaus Regling, the head of the fund said that including other EU member states' commitments and that of the IMF, the fund's capacity could reach about € 700 bn. Is it much? It is hard to say, as the Greece rescue efforts already amounted to more than € 100 bn.

Generally, the bailout idea is not treated equally among the big EU member states. Thus, the German government and other strong economies, commonly fear that their sovereign solid credit ratings could be diluted by the states in crisis, e.g. Ireland, Greece, Spain, etc. Presently fiscally weak euro-zone countries do not have other choices but to take into consideration "big states" advises. The final outcome is glass-clear: either the 16-eurozone states stand firm together or fall separately.

2. The second option was more controversial: it is the idea of European sovereign debt market as a secondary liquidity facility (the idea is shared by the Dutch and Italian governments). Such market could be most important for the euro-zone E-bond; ECB is already active in purchasing euro-zone sovereign debts. Since the start of December, ECB bought about € 2 bn bonds in the EU critical states (17). Organizationally it would be a European Debt Agency with a mandate to issue "E-bonds" equivalent to 40 per cent of the EU's GDP (as a discount, swaps of national bonds for E-bonds could be possible).

Some argue, however, that even if E-bonds could help in resolving the crisis, they would not solve the eurozone members' creditworthiness. Besides, "common bonds" would transfer subsidies from the fiscally sound to the fiscally unstable states.

Several EU states resisting any increase in the size of the European Financial Stability Facility, even though the current € 750bln funding may not be enough to keep all the states out of danger. A turn to the EU single bond market would provide evidence that the member states have chosen a common solution for a European-wide bond market. However, jointly guaranteed bonds would require substantial changes in the new Lisbon Treaty, the option which needs to be accepted by the member states.

Most certainly, definite solutions about the choice of further steps to resolve the crisis in the EU will not appear at the end of 2010; we expect additional efforts in strategy and plans in 2011 as well.

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(to be continued)