INTRODUCTION

This chapter seeks to understand the motivations behind the eurozone sovereign debt crisis and its possible outcomes for the so-called ‘PIIGS’ group of Member States (made up of Portugal, Ireland, Italy, Greece and Spain). It focuses especially on the case of Italy.

It is argued that the crisis was mostly triggered by the global financial crisis, which exacerbated a structural problem of competitiveness embedded in the way in which the Economic and Monetary Union was originally devised and implemented. By no means was the crisis only the result of an unsustainable fiscal position in the PIIGS Member States. If anything, it confirmed the lack of sustainability of a structurally asymmetric monetary union in the wake of an extremely serious economic shock. This has meant bringing the PIIGS group to the verge of the abyss, despite many voices having warned at the onset of EMU about the need for more symmetric arrangements in Europe and the development of more fiscal and political integration.

This chapter addresses the above issues, starting with the exceptional nature of the global financial crisis. It will start by analyzing how the global financial crisis unfolded and how it sparked a run on the sovereign debt of the weakest EMU countries. It will then proceed by identifying the solutions that have seemingly been found to the crisis with particular attention to the case of Italy. It will conclude by assessing the future of the EMU and, in particular, the extent to which the development of a new eurozone governance system is likely to become reality.
1. THE ORIGINS: THE GLOBAL FINANCIAL CRISIS

In August 2007, the financial crisis hit the global economy unexpectedly, producing consequences comparable to those experienced during the course of the 1930s. One of its most serious characteristics, unlike previous financial crises in the 1990s and early 2000s, was that it originated at the very heart of the global economy, the United States, before spreading first to the most developed countries in Europe and Asia (Stiglitz 2010). It is clear, however, that although the crisis originated in the US housing and mortgaging markets, it found fertile ground in the uncontrolled possibility of the financial markets to develop and sell new financial instruments that allowed the banking sector to greatly expand its capacity to extend loans and provide mortgages even to the least solvent clients. Indeed, whether or not customers were able to repay their mortgages was of no interest for mortgage lenders who were earning a commission for each signed mortgage deal and therefore had a vested interest in multiplying the number of loans (Gamble 2009). Mortgage dealers could sell the home loans they had provided to their clients back to investment banks, where they could then be mixed with other securities and resold as ‘investment-grade’ mortgage-backed securities (MBS)\(^1\). These securities were yielding very high interest rates, because they included sub-prime loans made to people with low credit scores. Yet they were often awarded ‘triple–A’ ratings by the major credit-rating agencies, who were paid fees directly by the issuers and therefore had a vested interest in giving the highest ratings to their securities (Gamble 2009:21). The combination of high interest rates and high ratings allowed for a rapid and uncontrollable spread of these ‘toxic’ assets whose returns were so appealing that the banking sector itself, to maximize its profits, set up highly leveraged, off-balance-sheet, structured investment vehicles (SIVs) to buy and hold some of these securities on their own accounts (ILO 2009).

This speculative bubble exploded when the increase in interest rates made it impossible for sub-prime mortgages to be repaid, with the consequence that many borrowers defaulted. From that moment onward, the crisis snowballed from the housing market to the banking and financial sectors in an unstoppable fashion (Gamble 2009:22).

There is to date a thriving literature concerning the causes of these events, but here is not the appropriate place to address it all. Broadly speaking, and with no ambition of being exhaustive of the subject, accounts of the origins of the crisis can be divided into three groups: 1) critical approaches, which identify the origins of the crisis in the inherent contradictions of the capitalist system (Gamble 2009; Callinicos 2010; Konings 2010); 2) supporters of the global imbalances thesis (Smith 2010; Davies 2010; Stiglitz 2010); 3) those who tend to focus exclusively in the faults of US macroeconomic policy-making (Woods 2009; Goodhart 2009; Munchau 2010; Huertas 2010; Gup 2010).

For the purposes of this contribution it is very important to distinguish the global financial crisis from the economic and fiscal crisis that accompanied and followed it (Huertas 2010:38). Again, no attempt can be made here to analyse in depth the interconnections between these three separate crises (Huertas 2010:38).

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\(^1\) Among similar securities there were: RMBSs (Residential Mortgage Backed Securities), CDOs (Collateralized Debt Obligations), SIVs (Structured Investment Vehicles) and CDOs of CDOs
As far as the global financial crisis is concerned, scholars identify five different stages in its unfolding (Orlowski 2008). The first stage is the collapse of the US subprime mortgage market. This spilled over into the credit market with a credit crunch that led to a third phase, represented by the liquidity crisis. The fourth phase was represented by the commodity price bubble and the fifth one by the demise of investment banking in the US (Orlowski 2008).

In February 2007 there were already warnings that the situation in the American subprime lender industry was unsustainable. However, it was only in August 2007 that it became clear that the crisis had moved from the American mortgage sector to the global financial and banking ones (ILO 2009).

As no one knew the exact share of ‘toxic’ assets held by anyone else, a drastic decrease of trust among financial operators produced an unprecedented reduction of credit, which soon took the form of a liquidity crisis. Liquidity in the inter-bank markets disappeared in a few days, to the extent that by September 2007 there was speculation that various financial institutions were receiving most of their funding from wholesale money markets (ILO2009).

In the UK, Northern Rock became the first institution to witness a bank run for about 150 years. The situation was solved only thanks to the intervention of the Bank of England, first bailing it out and then nationalising it.

In the meantime, the global banking sector started experiencing huge losses; on the 5th of October, 2007, Merrill Lynch reported a loss of US$5.5 billion and three weeks later came back with a figure over US$8 billion (ILO2009). The losses on the mortgage derivative market also triggered a massive run on Bear Stearns liabilities. On the 13th and 14th of March 2008 they fell by US$ 17 billion (Orlowski 2008:10).

At the beginning of 2008, after the massive losses that financial institutions had incurred on mortgage backed securities and other derivatives, they started investing in commodity futures, especially the crude oil futures markets, giving rise to the fourth stage of the global financial crisis. As a consequence, NYMEX oil futures prices experienced almost a 100 per cent increase from US$ 75 per barrel in the beginning of October 2007 to their peak of US$ 147 on 11th July, 2008 (Orlowski 2008:11).

In the fifth phase, beginning in September 2008, the asset bubble moved from commodity futures to US Treasury bills and gold. Banking liquidity froze and the world suddenly realized the extent of the crisis. On 15th September, 2008, Lehman Brothers filed for bankruptcy and Bank of America agreed on a US$50 billion rescue bid for Merrill Lynch (Sinn 2010).

The peak of the crisis was reached on the 28th of September, when US President George Bush took to the podium to urge the House of Representatives to pass a bailout plan worth US$ 700 billion. His call remained unheard and a few hours later, the House of Representatives rejected the bailout. Wall Street was shattered. The Dow Jones decreased 777 points—it’s biggest ever fall in points terms. In the meantime, in Iceland, the government was forced to take control of one of the nation's biggest banks. Asian stock markets were the first to react to the shocking news that the US$ 700 billion Wall Street bailout had failed. In London, banking shares were destroyed. Anyone who had savings was trying desperately to find a safe haven with government-backed national savings and investments, which were swamped by savers. The banks themselves were also finding it increasingly difficult to raise financing with the cost of inter-bank borrowing experiencing its biggest ever one-day rise.

Dominique Strauss-Kahn, the managing director of the IMF at the time, believed a bailout was the only option for the US economy and on 2nd October, the US Senate voted in favor of it. In the meantime, European leaders were considering their own bailout, which could cost up to €300 billion. The French president, Nicolas Sarkozy, led the talks2.

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2 See The Guardian online, www.guardian.co.uk as accessed on October 9th 2012
On 4th October, Gordon Brown attended an emergency summit in Paris to discuss the crisis with his French, German and Italian counterparts. On the 7th October, the British Treasury announced what amounted to a £500 billion bank rescue package to stop the country’s financial system from collapsing. Most bank shares fell again. At 12pm, the Bank of England, the US Federal Reserve and the European Central Bank all cut half a point off their key interest rates in the first unscheduled rate moves since the aftermath of the terrorist bombing of September 11th 2001. At first, stock markets were calm after the turmoil³. The FTSE 100 jumped 61 points by midday and banks continued to recover following the UK government's £500 billion rescue plan announcement from the previous day. However, the London market failed to hold on to early gains. With Wall Street in decline yet again, on 10th October the FTSE 100 closed 8.85 per cent lower, at 3932.1—a 381.7 point fall, destroying about £ 89.5 billion of the value of Britain’s biggest companies. It was the worst daily fall since the crash of 1987. On 11th October, Alistair Darling attended meetings in Washington with the G7 finance ministers and the IMF. The G7 devised a five-point plan, which included spending billions of dollars to rebuild the global banking system and reopen the flow of credit⁴.

On the 12th October, Gordon Brown traveled to Paris where European officials tried to solve the European banking crisis. He succeeded in persuading the EU’s core countries to adopt a plan along the lines of his £ 500 billion banking system bailout (Huertas 2010:60-75). On the 13th, the 15 members of the Eurozone, led by Germany and France, proposed to follow British plans to provide their banks with extra funding. In the meantime, the British government announced it would put £37 billion of emergency recapitalisation into the banks Royal Bank of Scotland, HBOS and Lloyds TSB. The prospect of governments pumping vast sums into banks on both sides of the Atlantic was warmly greeted by the financial markets. The FTSE 100 closed 325 points higher at 4256.9, a rise of 8.3 per cent. The Dow Jones increased by 936 points to 9387, its biggest one-day gain in terms of points. It closed up 11 per cent, the largest daily gain in percentage terms since 1933⁵.

It seems that the decision to pump such an enormous amount of public money into the global financial markets avoided the global catastrophe. But the financial crisis had already spilled over into an economic crisis, with Ireland being the first Eurozone country to technically enter into recession in September 2008 (Sinn 2010). In only two years, the world as a whole experienced a GDP reduction of 6 per cent, from 5.2 per cent to -0.8 per cent, the sharpest ever recorded in history (Sinn 2010:6).

In the eurozone GDP fell even more sharply, recording an incredible loss of 9% from 3.8% in 2007 to -5.2% in 2009 (Figure below).

³ Ibidem
⁴ Ibidem
2. THE EUROZONE SOVEREIGN DEBT CRISIS

The last phase to date in the unfolding of the crisis was the outburst of a sovereign debt crisis in the Euro area, first in Greece, in May 2010, then in Ireland at the end of November 2010, and finally to all the members of the so-called PIIGS group (including Portugal, Ireland, Italy, Greece and Spain).

Greece was the first casualty in May 2010. The fact that its debt had been downgraded by Moody’s a few days prior did not help to avoid speculation, as well as the long time taken by other members of the euro-area before deciding to provide a rescue package. This package included the establishment of an ad hoc European Financial Stability Facility\(^6\). Second in line was Ireland, which was plagued by the ongoing crisis of its banking system at the end of November 2010. Although its European partners had approved a rescue plan providing an overall €85 billion (€35 billion to bail out the Irish banking system with the remaining € 50 billion to help the government’s day-to-day spending), the markets insisted on increasing the yields required to buy Irish bonds (as well as Greek, Portuguese, Spanish and Italian ones)\(^7\). Amid serious worries for the stability of the entire system, on 16\(^{th}\) and 17\(^{th}\) December, 2010 the European Council moved toward the institutionalisation of a rescue tool called the European Stability Mechanism (ESM), which was officially launched on 8\(^{th}\) October 2012\(^8\).

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\(^7\) Ibidem

However, in December 2010 the financial and economic situation in Europe and especially in the eurozone was still heavily compromised. The main problems were found in the interplay between sovereign debt difficulties and the weakness of the banking sectors of some countries with the euro. Taken together, these issues could bring serious consequences for the sustainability of the EMU as a whole.

In its assessment of the main risks for the financial stability of the eurozone, the ECB differentiated between sources outside the financial system and sources of concern inside it (ECB 2010). Outside the financial system, the main sources of risk for eurozone financial stability included: the possibility of new concerns with respect to the sustainability of fiscal stances in some Member States; a resurgence of global imbalances; vulnerability of non-financial corporations’ balance sheets; and macroeconomic problems related to the increase of unemployment and related reduction of private credit. Within the eurozone financial system, important risks included the possibility of new strains to the financial system; more problems with banking exposure to bad debt; increase in the volatility of financial markets in the lack of macroeconomic recovery (ECB 2010).

The main worry that remained, however, was concerning the lack of sustainability of public finances in some eurozone countries, which had prompted market speculation against Greece. This had already created an adverse feedback loop between lower economic growth, bank funding vulnerabilities and fiscal imbalances, as was reflected in increases in the persistently growing spread between eurozone sovereign bond yields (ECB 2010). On the other hand, the profitability of many eurozone large and complex banking groups (LCBGs) continued recovering in the second and third quarters of 2010, demonstrating how the banking sector had succeeded in shifting the burden of the financial crisis (ECB 2010). Finally, concerns were voiced with respect to the possibility that global financial imbalances could widen again, thus creating new strains on the fiscal and financial sectors of some eurozone countries (ECB 2010).

Similar worries were confirmed in 2010 and 2011 when the Greek, Irish and Portuguese spreads with the German Bund hit, respectively, 1600, 1200 and 1100 basis points in July 2011. Also, the Spanish and Italian sovereign debt spreads with the Bund reached 400 basis points, Belgium hit 200 basis points and France hit 90 basis points (ECB 2012).

In 2012 the situation was still extremely worrying, with Spain having to accept a sort of bailout for its endangered banking sector of about 100,000 million euros and Italy being widely considered the next in line.

Much of the blame for the sovereign debt crisis has been put on the dire situation of the PIIGS fiscal stance. Although it cannot be denied that the countries considered were not enjoying a healthy budgetary situation, it must be noted that the policy of fiscal stimulus to combat the crisis came at a high cost for the fiscal position of many other countries. For example, the newly elected Obama administration introduced a stimulus package of $ 800 billion, bringing the budgetary deficit to 10 per cent of GDP in 2009. A similar figure was envisaged for the same year in Japan, while in the UK the deficit to GDP figure was almost 13 per cent. In the eurozone, the deficit to GDP was on average only 6 per cent in 2010, whereas in the mid1990s it had reached more than 7%.

9See Financial Times, June 13th 2012; available at http://www.ft.com/cms/s/0/d2d42d1e-b36c-11e1-83a9-00144feabdc0.html#axzz1xURTAr3 as accessed on June 13, 2012

First, some of the countries which have since been affected by the most serious wave of attacks to their sovereign debt were by no means performing so badly in terms of deficit to GDP in the course of the crisis. In 2010, when the attacks started, Greece had a deficit to GDP of 10.3%, only 4.3% higher than the eurozone average which was 6% at the time. Portugal and Spain with 9.8% and 9.3% respectively were just around 3.8% and 3.3% higher than the eurozone average. Italy had actually been doing quite well in the course of the crisis, better than the average of the eurozone, with a deficit to GDP of only 4.6% in 2010, which had even declined from 5.4% in 2009. Of course, commentators then blame the Italians for having an outrageous debt to GDP ratio. However, it is worth noting that in 1995 this ratio was 121.5% against an average of 72.5% in the rest of the future eurozone, whereas by 2010 the difference between the Italian performance and the average of the eurozone had actually decreased from 49% in 1995, to 34%. Moreover, in 2010 Spain had a debt to GDP ratio of 61.2% much below the eurozone average of 85.2%, and also Ireland and Portugal were not doing that bad with figures of 92.5% and 93.3% respectively.

Finally, similar performances of the deficit and debt to GDP ratio must be seen in the context of spectacularly declining levels of GDP which by definition, if only for mathematical reasons, increase their values. Between 2007 and 2009, Ireland lost 12.2% of its real GDP, Greece 6.5%, Spain 7.2%, Italy 6.8% and Portugal 5.3% (Figure below).

**Figure 2: Real GDP loss 2007-2010**

![Real GDP loss 2007-2010](image)

Source: EUROSTAT elaboration of the author

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11Ibidem
12Ibidem
13Ibidem
In an effort to identify the relation between the global financial crisis and the crisis of the eurozone, it is important to ask, along with the relevant literature, two questions: 14

First, are the larger spreads recorded in the course of the crisis a consequence of larger fiscal deficits and debt or do they show a change in the attitude of the markets towards the pricing of government credit risk?

Second, to what extent did the global financial crisis modify the attitude of the markets towards credit risk in the direction of more risk aversion?

The empirical results of a study conducted by the ECB shows that markets penalised fiscal imbalances much more strongly after the collapse of Lehman Brothers in September 2008, to the extent that coefficients for deficit differentials were 3-4 times higher and for debt differentials 7-8 times higher during the crisis period than earlier (Manganelli et al 2009). So, to answer the first question, the markets clearly changed their attitude towards pricing of government credit risk in the course of the global financial crisis and in its aftermath. But why did they do that? First the study underlines how there was a significant increase in bond spreads due to a general increase of risk aversion. This makes a lot of sense if we think that over the course of the crisis, the collapse of the stock exchange and of the housing market together with a general uncertainty about exposure to very risky assets of most of the banking system made it imperative to look for safe havens to invest in. We have already underlined how the price of commodities such as gold and oil went up as a consequence of the general instability of other forms of investment, and how this lead to a commodity price bubble which is considered in the literature as the fourth phase in the development of the crisis (Orlowski 2008). Also government bonds in the US and, after the start of the crisis, Germany, the benchmark in the euro-denominated bond market, assumed a safe-haven investment status. Furthermore, not only were investors/markets generally more risk averse, but they were also penalizing fiscal imbalances much more strongly than before September 2008, as demonstrated by the ECB study. These two factors account for much of the spread increase for EU country government bonds relative to German or US treasury benchmarks (Manganelli et al 2009).

It is indeed remarkable that US government bonds, the country where the crisis had started and which was experiencing huge fiscal imbalances, instead of becoming more risky were unanimously considered by the markets as a safe haven in which to invest in a period of instability.

The case of Germany, however, is less puzzling. In the whole process of European monetary integration, from the establishment of the exchange rate mechanism of the European Monetary System onwards, Germany had been the ‘1’ country of the ‘n-1’ problem, i.e., the country with the strongest currency which could, because of the technical characteristics of the fixed exchange rate arrangement, define the monetary policy for all the members of the currency agreement (De Grauwe 1996:27). More specifically, the ‘n-1’ problem entails that in a fixed exchange rate system there are only ‘n-1’ independent exchange rates, and therefore, while ‘n-1’ countries have to use their monetary policy so as to keep their exchange rate fixed, there is always ‘1’ country, the one with the strongest currency, which is free to set its monetary policy independently of exchange rate constraints. Moreover, by definition, the ‘1’ country is the one with the strictest, more credible, anti-inflationary monetary policy which allows its currency to be stronger than the currencies of the other members of the Union. This, however, has evident consequences for the competitiveness of the ‘n-1’ countries which by definition experience higher inflation rates and therefore progressively lose competitiveness up to the point at which their exchange rate peg becomes unsustainable and the markets can successfully speculate against their currencies.

Although, clearly, in the economic and monetary union there is only one monetary policy and no exchange rates, first the global financial crisis and then the economic crisis made it clear to what extent the asymmetries and the ‘n-1’ problems that had already affected the ERM of the EMS persisted, and were actually much more serious, in the EMU.

Indeed, for the ‘n-1’ countries joining the EMU meant progressively appreciating their real exchange rate, and this is particularly true for the least competitive countries whose currencies tended to devalue more often before the establishment of the EMU, i.e., the PIIGS countries. On the other hand, the ‘1’ country, Germany, joined the EMU enjoying a progressive depreciation of its real exchange rate which, together with the impossibility of any competitive devaluations by the other members of the EMU, progressively increased its competitiveness. What is important to underline here is that this is a structural characteristic of the EMU which was inherited from the previous exchange system but was made more serious by the fact that in the EMU there is no possibility to re-gain competitiveness through devaluation. This trend is clearly visible looking at the power purchasing parity real exchange rate (RER)\(^\text{15}\) of the PIIGS in relation to Germany based on the average consumer price index from 2000-2012 (Figure below).

\(^{15}\) The formula for the RER used here is given by:

\[
\text{RER} = e \left( \frac{P^*}{P} \right)
\]

Thus, from the start of the EMU, Germany enjoyed a structural bonus of competitiveness which increased progressively, as, indeed, had been predicted by many EPE scholars (Frieden 1991, 1994, 1998; Eichengreen and Frieden 1994; Moravcsick 1998; Chapter 1 part 2). Of course, exchange rate devaluation is considered in the economic literature as a very bad way to regain competitiveness. Much emphasis was therefore placed on what is normally referred to as ‘internal devaluation’, or ‘supply side economics’ which basically means reducing the costs of production by increasing productivity and/or reducing labour costs. Indeed, the EU approached and still approaches the whole question of growth and employment by relying significantly on labour market flexibility, the rationale of which is often neo-functionally linked to the establishment of EMU. Furthermore, the implementation itself of flexible labour market policies was made possible by the strengthening of the bargaining power of employers’ organisations, which was reflected in the institutionalisation at the European level of the neo-liberal economic paradigm focusing on the implementation of strict monetary and fiscal policies (Chapter 6 Part 2).

However, despite the EU rhetoric and practice on structural reforms, these were clearly not enough to overcome the competitiveness gap between Germany and the weakest countries of the eurozone. The global financial and economic crisis led the markets to believe that the competitiveness gaps accumulated over the years between the core and the periphery of the Union was unsustainable. Indeed, Arghyrou and Kontonikas (2010) argue that the performance of the spreads in the course of the global financial crisis was due to both an international risk factor, measured by the US Stock Market Implied Volatility (VIX) and a country specific macro factor represented by the loss of international competitiveness.

In short, both the need to find a safe haven for investment in times of uncertainty and the fact that some countries’ overall macro-economic and fiscal position was judged unsustainable because of a lack of international competiveness, made the markets believe that betting against the weakest countries of the system was safe. In the lack of national exchange rates, currency speculation was obviously impossible and the markets reverted to speculation on sovereign debt, dramatically increasing the spread between the bonds of the countries under attack and the bonds of those countries which were considered stronger, primarily Germany (Arghyrou et al 2010; Monfort and al 2011).
Summing up, more than a shelter against the worst consequences of the global financial and economic crisis, the EMU, as designed at Maastricht and implemented in the following years proved a highly asymmetric arrangement. It signalled to the markets which countries were unlikely to sustain the economic shock, thus unleashing speculation.

In the next section we will investigate how one of the PIIGS, Italy, tried to placate the hunger of financial markets.

3. PIIGS FOR SALE. THE CASE OF ITALY

From the second half of 2011, Italy experienced an increased pressure on its sovereign debt from financial markets. From July to November 2011 the spread between the Italian BTPs (Italian 10 year treasury bills) and the German Bund, a common measure of such pressure, surpassed 400 basis points on many occasions. Although it was generally felt that the situation was extremely serious, this indicator tends to maximise the effects of the pressure on interest rates as it is strongly influenced by the reduction of the interest rates paid on the Bund, which, given the instability of the global economy, were selected by investors as a safe heaven.

In the same period, the interest rates of Italian long term debt emissions increased steadily to reach quota 6.99% in November 2011. However, the Bank of Italy noticed how the fiscal position had not yet become unsustainable. First of all, during the crisis Italian debt did not remain unsold and the allocation of Italian Treasury bills happened regularly.

Moreover, in June 2011 Italian public debt was around 1900 billion Euros. Only 39.2% was held by foreign investors, which is a relatively small percentage as compared to other European countries. Italian families held the biggest part of the debt, with residents holding around 14%, followed by banks, insurance companies and funds. The composition of debt ownership did not change substantially in the course of the crisis apart from an increase in the quota held by Italian banks.

Finally, some the pressure on Italian debt needs to be inserted in the context of a liquidity shortage which brought many European investors to sell assets.

16 See Bank of Italy 2011
17 Ibidem
18 Ibidem:61
Despite some evidence to the contrary, there was a widespread belief that Italy was on the verge of default. The political equilibrium of the country, resting on the centre-right government of Silvio Berlusconi, was shattered to the point of no-return. Amid fears of a fiscal melt down, Mario Monti, a technocrat with great experience both of the EU and of financial markets, was able to form an unelected government with the only ostensible aim of calming down the markets and allowing the fiscal crisis to ease.
What was the price that the markets asked in exchange for a truce on their attacks to the Italian sovereign debt? There is no doubt that much of Monti’s success in calming down the markets was due to a decree on market liberalisation. The Italian capitalist system has long been known for being extremely closed to foreign investment allowing Italian capital to keep control of the Italian economy. It revolved around a web of cross-shareholdings that allowed the financial and corporate elite to sit on each other’s boards and wield influence over several companies often through only a small stake.

Mario Monti identified the dismantling of this so called Italian ‘SalottoBuono’ (i.e. the Italian establishment) as the price to pay to financial markets. Indeed in Mr Monti’s ‘Save Italy’ liberalisation decree it was made clear that from 25th April, 2012 it would be illegal to hold a board seat in more than one financial institution operating in the same market. The aim was clearly that of opening to foreign financial capital Italy’s triumvirate of boardroom power, UniCredit, Generali and Mediobanca, where no less than six men sit on at least two out of the three boards.19

Moreover, these companies were linked by cross-shareholdings. Mediobanca owned 13 per cent of Generali and 7 per cent of UniCredit via a structured finance deal. UniCredit owned 9 per cent of Mediobanca. It is worth noticing that through this system, Mediobanca, the productive investment powerhouse of Italy, the mother of Italian family capitalism, influenced strategic choices at Generali, Europe’s third-largest insurer by assets. By eliminating such a link, Italian capitalism was out for sale to the same financial markets that attacked its sovereign debt.

Mr Monti’s decision was very controversial in Italy, where discussion opened on whether there was a loophole in the decree and if article 36 really meant what it appeared to say. As one senior board member of an Italian bank said: ‘If you have one or two of those seats, you really don’t want to give them up.’20

But it seems clear that Monti was determined to put Italian relationship capitalism to an end and satisfy foreign investors’ long term desire to get their feet in the door by opening up a system that has traditionally been impenetrable to all but powerful insiders.

As Monti said at a press conference: ‘It is natural and dutiful for the government to be open to a dialogue with parliament, but some changes to the liberalisation decree did not ‘cannot and will not be welcomed’.21

To be sure, financial markets welcomed a similar approach. Riccardo Barbieri, of Mizuho International, praised Mr Monti’s government for its accomplishments but said the vote on the liberalisation package and the labour reform negotiations were ‘critical’. ‘Deregulation is necessary and will challenge the government’s ability to win concessions even from the strongest lobbies and to change the structure of the economy,’ he said.22

However, was this the only way by which the Italian Government could tackle the crisis of its foreign sovereign debt? If the problem is a structural one, as proposed at the beginning of the paper, is the sale of the Italian ‘salotto buono’ going to make a difference in the long term? What about changing the European economic governance system?

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19 See FT, 24/02/12
20 Ibidem
21 Ibidem
22 Ibidem
4. THE FUTURE OF EMU: TOWARDS A NEW EUROPEAN REGULATORY REGIME?

The need for an integrated European economic governance has been advocated in a number of occasions and, in theory, enjoys the support of leading EU politicians. At the European level, however, to date there is nothing like a pan-European regulatory regime for the EU and eurozone banking and financial systems.

At the end of 2012, four years after the global financial crisis, banking and financial supervision in the EU and eurozone remained in the hands of national central banks (Sapir et al 2012:1). Of course, some steps were taken to restructure what had proved to be a highly inadequate European regulatory regime for the financial and banking sector (Teixeira 2011). In terms of the redefinition of the EU approach to the regulation of the single financial market, shortly after the onset of financial crisis in 2008 the EU Commission President Barroso gathered a group of high profile experts, headed by Jacques de Larosière, to propose a new, integrated European system of supervision. On 25th February 2009 the group presented a report which represented the basis for the new European financial supervisory architecture proposed by the Commission in its Communication to the Spring European Council of March 2009. Further details on the Commission’s plan were contained in its Communication of May 2009. These included:

1) The establishment of a European System of Financial Supervisors (ESFS) composed of a network of national financial supervisors working in cooperation with new European Supervisory Authorities (ESAs). The latter would be created by transforming the existing European supervisory committees (Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and Committee of European Securities Regulators (CESR)) into a European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA) respectively.

2) The establishment of a European Systemic Risk Board (ESRB), in charge of macro-supervision of financial stability to be effected by providing an early warning of system-wide risks. This was to be accompanied by the possibility, if necessary, to issue recommendations to act against similar risks.

These proposals were discussed in the course of two open consultations. The first one, from 10th March to 10th April, 2009, followed the report of the de Larosière group and the publication of a Commission Communication on 4th March 2009. It informed the Commission Communication on Financial Supervision in Europe published on 27th May, 2009.

In the second consultation, from 27th May to 15th July, 2009, the Commission invited all interested parties to comment on the more detailed reforms presented in the May Communication on Financial Supervision in Europe. At this stage there seemed to be a great deal of support for the proposed ESRB and ESFS.

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23 See Financial Times, various issues
The transformation of the existing Committee of European Banking supervisors on 1st January, 2011 into the European Banking Authority (EBA) based in London, and the establishment of the European Securities and Markets Authority (ESMA) in Paris and the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt created the new European Supervisory Authorities (ESAs) to be inserted in the European System of Financial Supervisors (ESFS). However, this does not seem to have substantially resolved the issue of pan-European banking and financial supervision (Teixeira 2011). National authorities remain responsible for the day-to-day supervision of individual firms, with the new European architecture only providing an overarching European framework for financial supervision25. Moreover, the ESAs themselves comprise high-level representatives of all of the member states’ supervisory authorities under permanent chairmanships26. They have the power to temporarily ban certain high-risk financial products and activities, such as naked short selling, as well as instructing banks and other financial actors in crisis situations, drawing up standards for national regulators and settling disagreements between them27. However, this will be possible only in situations of emergency to be defined by the council and it is limited by a safeguard clause attributing to the member states the power not to abide by the decisions of the ESAs28.

Table 1 The European Supervisory Authorities

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<td>Committee of European Insurance and Occupational Pension Supervisors (CEIOPS)</td>
<td>Insurance</td>
</tr>
<tr>
<td>Committee of European Securities Regulators (CESR)</td>
<td>Securities</td>
</tr>
<tr>
<td>Colleges of supervisors for banking and insurance groups</td>
<td></td>
</tr>
<tr>
<td>National supervisors</td>
<td></td>
</tr>
</tbody>
</table>

Source: Adapted from Teixeira 2011:13

27 For more details see http://www.time.com/time/world/article/0,8599,2016359,00.html as accessed on December 21, 2010.
As in the Commission’s plan, the new ESAs are complemented by a group connected to the Frankfurt-based European Central Bank (ESRB). The ESRB monitors the risk of major threats to the economy, such as problems at major banks or asset bubbles (Teixeira 2011)\(^{29}\). Although connected to the ECB, the ESRB seems to be mainly a consultative body and its creation did not activate the idle clause in the Maastricht treaty that gives the ECB a formal role in banking supervisory policy (Art. 105(6))\(^ {30}\).

### Table 2 The framework for the ESRB risk warnings and recommendations

<table>
<thead>
<tr>
<th>The ESRB may decide to make warnings and recommendations public</th>
<th>COUNCIL COMMISSION (copy of all warnings and recommendations)</th>
<th>Potential addressees of ESRB warnings and recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EUROPEAN SYSTEMIC RISK BOARD</strong></td>
<td>The ESRB decides whether recommendation has been followed</td>
<td><strong>EU</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>MEMBER STATES</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>EUROPEAN SUPERVISORY AUTHORITIES</strong></td>
</tr>
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<td></td>
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<td><strong>NATIONAL SUPERVISORS</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>COMMISSION (recommendations on EU legislation)</strong></td>
</tr>
</tbody>
</table>

Given the shortcomings of these reforms to the EU banking supervision regime, made evident by the evolution of the eurozone sovereign debt crisis, at the end of June 2012 the European Union leaders agreed to set up a single supervisory authority to oversee 6,000 banks in Europe, with the aim of having it in place by the end of the year\(^ {31}\). The possibility of moving towards the establishment of a European banking union was supported by the European Council in its June 2012 summit. The conclusions of the European Council stated that:

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\(^{31}\) For the full report on the characteristics of the proposed European Banking Union see Sapir et al. (2012).
‘The Commission will present Proposals on the basis of Article 127(6) for a single supervisory mechanism shortly ... When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM [European Stability Mechanism] could, following a regular decision, have the possibility to recapitalize banks directly’ (Sapir et a. 2012:1).

Following this, the European Commission presented, on 12th September, three documents concerning the European Banking Union. The first one was a communication proposing a general outline for a banking union, including the provision of a single rulebook and single supervisory mechanism, as well as foreseeing the establishment of a single bank resolution mechanism. The second was the proposal of a Council regulation that would allow the European Central Bank (ECB) to activate its formal role as the only supervisor of all banks in the euro area, providing for the option for non-euro area countries to enter this arrangement on a voluntary basis. Finally, the Commission proposed a regulation of the European Parliament and of the Council which would adapt the regulation of European Banking Authority (EBA) to the new banking supervisory regime. This was intended to avoid problems of competence between the ECB and the EBA which would then remain in charge of maintaining the integrity of the Single Market32.

With these documents the Commission supported the idea of a European banking union that should be ‘composed of a single supervision mechanism, a European deposit insurance scheme and a common resolution system’ (Sapir et al 2012:1). It also seems clear that in the Commission’s plan the proposed single supervision system represented only ‘a first step towards the banking union’ (Sapir et al 2012:1). However many doubts were raised in the course of 2012 regarding the feasibility and characteristics of even this first step, most loudly from Germany33.

Eventually, the European Council conclusions on completing EMU that were adopted on 18th October, 2012 reiterated the need to move towards an integrated financial framework and invited legislators to proceed with work on the legislative proposals on the Single Supervisory Mechanism (SSM) indicating the 1st of January 2013 as the deadline to agree on the legislative framework. The definition of the legislation needed for its operational implementation would take place in the course of 2013. Most importantly, the European Council noted that only when an effective single supervisory mechanism was established, involving the ECB, the newly established European Stability Mechanism would be able to recapitalise banks directly34. This sparked a great deal of discontent, especially within the PIIGS groups, because some of the weakest countries, most notably Spain, had hoped for a quicker decision regarding direct bank recapitalisation through the ESM35.

32For the text of the three proposals see http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec1 as accessed on October 12, 2012
33See Financial Times, available at http://www.ft.com/cms/s/0/ad222a9a-19ff-11e2-a379-00144feabc0.html#axzz29rVFWKzW as accessed on October 20, 2012
35See Financial Times, available at http://www.ft.com/cms/s/0/ad222a9a-19ff-11e2-a379-00144feabc0.html#axzz29rVFWKzW as accessed on October 20, 2012
CONCLUSIONS: ASSESSING THE REACTION OF THE EU TO THE CRISES

Overall, the European Union does not seem to have been particularly well-equipped to cope with the financial crisis, nor does it seem as yet to have the political will and capacity to establish an effective regulatory regime for financial services at the regional level (Soedeberg 2010). The crisis of the sovereign debt in the periphery of the eurozone seems to have been the consequence of the combined effect of the global financial crisis and the structural asymmetries that had affected the EMU from its establishment.

The European Commission was taken completely by surprise by the global financial crisis and the subsequent recession. Moreover, European responses to the financial crisis have been fairly scattered and erratic, and EU authorities have not been capable of initiating coordinated responses to the crisis unless at the very last minute. The ECB did little to curb the expansion of the financial sector and to stop growing speculation in Central and Eastern European countries by powerful Western European banks, which as a result became heavily exposed. The Commission seemed to be more interested in liberalising the labour and product markets, whilst allowing for a widespread deregulation of the financial sector, UK style (Cafruny 2010). Equally, macroeconomic responses to the crisis have not been coordinated at the EU level. Stimulus programs were decided at the level of the nation state, had a national scope and produced a number of controversies regarding ‘financial protectionism’ concerning the support of national industry or national economic players vis-a-vis their European competitors. This might even have a disruptive impact on the EU as a whole, especially in the wake of the sovereign debt crisis affecting the weakest countries in the eurozone. Finally, external support for Europe’s periphery has been largely delegated to the IMF (Cafruny 2010).

All this must be inserted into the context of the limited potential of the euro as an international reserve currency. Although the international role of the euro had increased somewhat in the 10 years following its introduction, there are a number of limits to its further expansion. The improvement in the international role of the euro took place mainly in its first years of existence (up to 2002 and 2003). Subsequent developments have essentially been due to the appreciation of the European currency with respect to the US dollar or are limited to the eurozone’s neighbouring countries. This has been reversed with the outburst of the crisis. Furthermore, there does not seem to be sufficient scope for furthering the development of the euro as an international currency in the political, institutional and ideological framework of economic policy making in the EU as the sovereign debt crisis has perfectly made clear. As a consequence, the idea of the euro rivalling the dollar as an international reserve currency remains largely a dream (Plashcke 2010).

These institutional constraints may be removed in the future. The current global financial and economic crisis could indeed have stimulated further reflection on the role of the EU and the euro in the international monetary system and on global economic governance. However, although at the onset of the global crash the weaknesses of the US economy were fairly evident, this did not lead to a run on the US dollar or to a strengthening of the international role of the euro. On the contrary, rather than exposing the limits of global dollar dominance, the crisis has highlighted a lack of either credible alternatives to US power (monetary and otherwise) or a capacity for the EU to take the lead of the global economy (Plashcke 2010). To be sure, it was the US Federal Reserve and Treasury, not the European Commission or the ECB, to act as the leading institution in crisis management and provide for the much needed role of ‘lender of last resort’ at the onset of the global financial crisis (Cafruny and Talani 2012).
There is, finally, very little evidence of growing European solidarity in the face of recession. For example, Central and Eastern European countries have been in a very dire situation, experiencing a serious decline in their industrial production as well as the bursting of a housing bubble with all that entails in terms of capital shortage. This was further aggravated by the almost complete dominance of the CEEC’s banking system by Western banks, especially Austrian, German, Italian, and Swedish (Cafruny 2010). Indeed, the depth of the recession in the East was a consequence of the failure of a post-1989 growth model that was embedded in the EU accession program and based on the dominance of foreign finance, the integration of Eastern economies into the Western financial model, and regulatory convergence with the EU (Cafruny 2010). The risk was that the CEECs would collapse both economically and socially as a consequence of the outflows of foreign capital. Eventually, the situation was kept under control not so much by the intervention of the EU Commission as by the loans provided by the IMF, which says a lot about the degree of solidarity in the EU. Since November 2008, the IMF has agreed to intervene to financially support eleven countries in the region, starting with Latvia, Hungary, and the Ukraine. Among them, only Poland has received special treatment by virtue of its positive track-record in financial stability. The other countries had to implement pro-cyclical structural adjustment programs that certainly had serious repercussions on the standard of living and the employment level of their populations. All of this took place under the wings of the IMF, as if entry into the EU had never happened. (Cafruny 2010; Cafruny and Talani 2012)

Something more has been done to react to the sovereign debt crises affecting Greece and Ireland within the eurozone, and spreading quickly to the other members of the PIIGS group. This, however, took the form of mainly ad-hoc decisions providing for impromptu solutions lacking institutional depth and democratic legitimacy, such as the European Financial Stability Facility (EFSF)\(^\text{36}\). A more institutionalised rescue mechanism for member states of the eurozone under attack for the lack of sustainability of their fiscal position was approved in December 2010. This took the form a European Stability Mechanism (ESM)\(^\text{37}\); although it is debatable whether these plans will be likely to solve the problem of credibility and lack of coordination of the European economic governance system.

The ECOFIN Council deliberated on the establishment of the European Financial Stability Facility (EFSF) on 9th May, 2010. The total endowment of the Fund to rescue eurozone countries in crisis was €750 billion. This included the possibility for the EFSF to issue bonds guaranteed by EuroArea Member States (EAMS) for up to €440 billion for on-lending to EAMS in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and International Monetary Fund and to be approved by the EUROGROUP. The EFSF enjoyed a triple A credit rating awarded by the most influential agencies: Standard & Poor’s, Fitch Ratings and Moody’s. The EFSF was, however, only a temporary arrangement\(^\text{38}\).


To avoid further spreading of the sovereign debt problems to other countries, in December 2010 the European Council opted for the institutionalisation of a European Stability Mechanism (ESM), which was inaugurated in October 2012 after a long and controversial ratification process. With the establishment of the ESM, the EFSF started its phasing out.

The role of the European Stability Mechanism (ESM) is similar to the one of its predecessor and consists in providing financial assistance to Euro Area Member States experiencing financial problems. The funds used by the ESM to achieve its aims are raised by issuing money market instruments as well as medium and long-term debt with maturities of up to 30 years. These assets are backed by capital provided by the EAMS according to the contribution key annexed to the ESM Treaty. Whether the funds raised by the ESM would be enough to cover the re-financing needs of big EAMS in difficulty, such as Italy and Spain, and therefore stop market speculation, is very debatable. To be sure, the ESM is supposed to cooperate very closely with the International Monetary Fund, to the extent that any EAMS requesting financial help to the ESM are expected to also address the IMF with a similar request. This is already a sign of the limited potential of this mechanism in a situation of serious crisis.

Overall, despite the establishment of the ESM, it seems inevitable that the only real rescue mechanism for any big EuroArea Member State in serious financial strain would be the European Central Bank, acting as a hidden lender of last resort. Actually, the European Central Bank is still far from becoming the official ‘lender of last resort’ of the eurozone area, something that would be more than natural in a currency union. However, in the wake of the collapse of Lehman Brothers in October 2008, the ECB started a novel mode of monetary policy relying not only on conventional measures, such as interest rate cuts, but also on ‘non-standard measures’. These included ‘enhanced credit support’ and ‘securities markets programs’. Such measures configured a new role for the ECB as ‘hidden/modern lender of last resort’ or, as referred to in some scholarly interventions as ‘intermediation of last resort’ (Giannone et al 2011). The enhanced credit support relies on (a) increasing the share of liquidity supplied at its long-term refinancing operations (LTROs) relative to its regular main refinancing operations (MROs); and (b) increasing the maturity structure of its LTROs. Most importantly, all of the ECB’s re-financings would be conducted on a ‘fixed-rate full allotment’ basis, rather than a variable rate tender format, as used before. In other words, contrary to normal practice, financial institutions were allotted the full amount of liquidity that they want at the prevailing interest rate, which was very low.

Moreover, the program allowed the Eurosystem to accept assets that had become illiquid in financial markets (notably mortgage-backed securities) as collateral in its refinancing operations. In its operations, the euro-system provided cash loans against the security of these assets. Finally, the Eurosystem increased the number of counterparties eligible for Eurosystem operations from 140 to around 2000 and started protecting the counterparties’ anonymity to avoid domino effects (Giannone 2011).

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39 The ESM Treaty entered into force on 27th September 2012. All seventeen euro area member states had ratified by 3rd October 2012.
As accessed on October 12, 2012
As accessed on October 12, 2012
Since 2008, the ECB has successively introduced six-month, twelve-month and thirty-six-month terms for LTRO finance. Each of these new issues has been heavily subscribed, with eurozone periphery banks in Ireland, Italy, Spain and Greece taking the majority of the first thirty-six-month issue in late 2011. The second thirty-six-month issue was in February 2012 and also this one was very successful with weaker eurozone banks.\(^{43}\)

In addition, in May 2009 the ECB announced a first €60 billion Covered Bond Purchase Programme (CBPP) to purchase euro-denominated covered bonds issued in the euro area over the period until June 2010. A CBPP2 started in November 2011.\(^{44}\)

The second non-standard component of the ECB’s response to the crisis, together with enhanced credit support measures, was the launch in May 2010 of the Securities Markets Programme (SMP). This allowed the Eurosystem to buy both private and public euro area debt. Given the constraints of the provisions of the Treaty on the Functioning of the European Union, eurosystem purchases of government bonds were strictly limited to secondary markets and fully sterilised by conducting liquidity-absorbing operations. On 6th September, 2012 the SMP was superseded by the Outright Monetary Transactions (OMT) allowing for the unlimited purchase of bonds of struggling countries in secondary markets. This is subject to conditionality, which implies that Member States willing to benefit from the OMT have to agree to the implementation of a full or precautionary ESM macro-economic adjustment programme. Also the IMF should be involved in the elaboration and monitoring of country-specific conditionality. The Governing Council of the ECB maintains the right to initiate, continue and terminate OMT with full discretion.\(^{45}\)

In addition to these measures, the eurosystem continues to provide liquidity in foreign currencies, most notably in US dollars.\(^{46}\)

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Summing up, with the so-called Long Term Refinancing Operations (LTROs) the ECB inaugurated three-year lending programs which provided virtually cost-free liquidity to banks. Thus, especially in the weakest eurozone, banks were incentivised to acquire the sovereign debt of countries under attack and gain from the interest rate differentials. Moreover, first the SMP and then the OMT rendered the role of the ECB as a ‘hidden lender of last resort’ more evident and effective, providing for a de facto sterilised monetisation of debt. Despite this, the German government has continued to prevent the ECB from transferring risk to its own balance sheet, as the Federal Reserve Bank has done, thus refusing to give the ECB an official role as ‘lender of last resort’.

A further step in the EU’s response to the eurozone crisis has been the approval by the European Council, on the 2nd March, 2012 of the so-called ‘Fiscal Compact (officially the Treaty on Stability, Coordination and Governance TSCG)’. The Contracting Parties agreed to keep the budgetary position of their general government balanced or in surplus. This commitment will be considered as met if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the Stability and Growth Pact, with a lower limit of a structural deficit of 0.5% of the gross domestic product at market prices. If the ratio of the general government debt to gross domestic product at market prices is significantly below 60% and there are low risks in terms of long-term sustainability of public finances, the lower limit of the medium-term objective specified could reach a structural deficit of at most 1.0% of the gross domestic product at market prices. In case of significant observed deviations from the medium-term objective or the adjustment path towards it, a correction mechanism shall be triggered automatically.

47 See http://placeduluxembourg.wordpress.com/2012/03/02/ecb-market-intervention-the-securities-market-programme-smp/ as accessed on October 18th, 2012.
49 For the full text see http://www.european-council.europa.eu/media/639235/st00tscg26_en12.pdf.
The fiscal compact is far from being a real fiscal constitution for the EU, not least because the decision by the UK not to sign it has made it impossible to incorporate it into the EU Treaties, although it requires contracting parties to incorporate it into their legal systems at the constitutional level. In essence, the fiscal compact is just an intergovernmental agreement (De Grauwe 2012). Furthermore, notwithstanding the rhetoric, the fiscal pact represents little more than a replay of the Stability and Growth Pact, apart from the reference to structural budgets which, however, is considered by the experts more of a complication than anything else (De Grauwe 2012). Indeed two things clearly limit the capacity of the Fiscal Compact to be effective: first, there are no provisions for automatic sanctions, and second, the pact allows countries to temporarily deviate from the requirements of having their budgets in balance or in surplus in case of an unusual event outside the control of the government concerned or in periods of severe economic downturn52.

In conclusion, far from having been socialized among the members of the eurozone and of the EU through the adoption of a real common fiscal policy and the attribution to the European Central Bank of its natural role as lender of last resort, the burden of the costs of the crisis was inflicted on the weakest countries of the system. This happened through the imposition of savage austerity plans. Indeed, the main characteristic of the EU approach to crisis management, quite apart from the rhetoric about the establishment of a new economic governance, was ‘internal devaluation’ with all that means in terms of pro-cyclical effects, popular resistance, political instability and eventually the threat of disruption to the EU integration process as a whole. It remains to be seen if this is a price worth paying in exchange for fiscal consolidation.

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