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the Need to Make it Better (WP)**

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(1) Introduction

Something extraordinary has happened during the Global Crisis that started in 2007. Despite acute financial turmoil and massive injections of liquidity, exchange rates in the euro area have not faced the kind of speculative attacks that were the unavoidable feature of every previous crisis. The reason, of course, is that there are no exchange rates. This silent triumph of the monetary union is almost taken for granted because it is almost a tautology. It is much more than a tautology. In fact, it is the *raison d'être* of the monetary union. Member countries have given up their currencies, a powerful symbol of statehood, and their monetary policy autonomy for one major purpose: achieving exchange rate stability within the Single Market. In contrast, most of the EU countries that have not joined the monetary union have undergone heavy market pressure.

This blessing does not, of course, come for free. What was obvious at the start was that the price to pay for protection from currency crisis was the irrevocable loss of national currency and monetary policy. As is well known from the Optimum Currency Area literature, the loss is limited when the shocks are symmetric, meaning that monetary union member countries face similar macroeconomic conditions. The Global Crisis affected all countries, but some were more exposed to either toxic assets or to housing price bubbles, and the ability to cope with the consequences was not the same either. This question is examined in Section 0.

Section 0 looks at the benefits of euro area membership by examining the effects of the Global Crisis on non-euro area members. In several of these countries, exchange and interest pressure has been intense. Some countries have seen their currencies lose value very seriously. Interest rates generally rose to extremely high levels, offsetting whatever demand boost was obtained through depreciation.

A common currency is not the alpha and omega of monetary integration. In order to operate adequately, a monetary union needs to draw all the implications of a shared currency. One of them is the integration of financial markets. As this process deepens, and it seems to be taking years in Europe, financial institutions (markets, banks, funds) gradually become supranational. This raises new issues concerning regulation and supervision. The Global Crisis has shown that the euro area member countries were ill-prepared for the task. Section 0 looks at the situation and the ensuing debates.

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With a common monetary policy, member countries still have a macroeconomic policy instrument: fiscal policy. In principle, this instrument can alleviate the situation in presence of asymmetric disturbances, assuming that it works with adequate flexibility and effectiveness. But this possibility raises the question of coordination. Indeed, if national fiscal policies affect the whole euro area, possibly through the common exchange or long-term interest rates, should there not be some restrictions on national actions? The need to carry out expansionary policies during the Global Crisis has exposed disagreements between member states. The question of policy coordination is taken up in Section 0.

The last section summarises the main conclusions.

(2) What Difference Did it Make?

Of the EU's 27 member countries, 11 have not adopted the euro. Of these, five follow a hard peg *vis-à-vis* the euro, including currency board arrangements for three of them. The remaining six countries mostly let their exchange rates float freely, the main exception being Rumania, which has declared a managed float regime. The variability of these six countries' exchange rates *vis-à-vis* the euro is reported in the upper part of Table 1. In four countries (Hungary, Poland, Sweden and the UK) volatility has significantly increased since the onset of the crisis relative to the period from EU admission to the onset of the crisis. Only two countries (the Czech Republic and Rumania) have not faced higher exchange rate volatility. The lower part of the table reports the changes in the euro exchange rate of these countries between 2007:7 and 2009:3. With the sole exception of the Czech Republic, all currencies have depreciated relative to the euro by very significant amounts.

Table 1. Exchange rates *vis-à-vis* the euro: Coefficients of Variation

	Czech Republic	Hungary	Poland	Romania	Sweden	United Kingdom
2004:1-2007:7	0.053	0.034	0.071	0.075	0.015	0.015
2007:8-2009:3	0.053	0.073	0.103	0.073	0.063	0.093
Change 2007:7-2009:3 (%)	2.4	-19.2	-19.6	-25.5	-16.0	-27.3

Note: The coefficient of variation is the ratio of the standard deviation to the average.

Source: *International Financial Statistics*, IMF.

Exchange rates are a potent indicator of financial pressure, but they can conceal other channels. A country can struggle to defend its exchange rate by raising its interest rates, which is what countries which operate a currency board are committed to do. Such a defence can be painless if it only affects the very short-term policy rates, but it can have drastic implications if the whole yield curve shifts upwards. This is why Table 2 presents

the long-term government bond rates for all EU countries. A quick, albeit imperfect way of checking what happened is to look at the average for euro area and non-euro area members. Here again it can be seen that interest rates have become significantly more volatile among the non-euro area members while they have become more stable within the euro area. This evidence corroborates the impression given by Table 1.

Table 2. Government Bond Rates in the EU: Coefficients of Variation

	Average EA	Austria	Belgium	Cyprus	Finland	France
2004:1-2007:7	0.117	0.104	0.100	0.177	0.107	0.099
2007:7-2009:3	0.055	0.061	0.055	0.010	0.068	0.082
	Germany	Greece	Ireland	Italy	Luxembourg	Malta
2004:1-2007:7	0.100	0.094	0.106	0.096	0.118	0.048
2007:7-2009:3	0.124	0.092	0.096	0.046	0.052	0.060
	Netherlands	Portugal	Slovak Rep.	Slovenia	Spain	
2004:1-2007:7	0.102	0.102	0.152	0.106	0.102	
2007:7-2009:3	0.073	0.050	0.047	0.042	0.054	
	Average non-EA	Bulgaria	Czech Rep.	Denmark	Estonia	Hungary
2004:1-2007:7	0.122	0.148	0.138	0.112	0.106	0.104
2007:7-2009:3	0.124	0.171	0.055	0.098	0.131	0.164
	Latvia	Lithuania	Poland	Romania	Sweden	U.K.
2004:1-2007:7	0.145	0.096	0.145	0.035	0.125	0.077
2007:7-2009:3	0.297	0.521	0.047	0.104	0.150	0.167

Note: The coefficient of variation is the ratio of the standard deviation to the average.

Source: *International Financial Statistics*, IMF.

This evidence suggests that, in the absence of a common currency, several of the 16 euro area member countries would have faced severe turbulence in their foreign exchange markets. This conclusion is strengthened by the observation, presented in Section 4, that turbulence has led to large spreads in some countries (Greece, Italy, Spain and Portugal) where interest rate volatility has actually declined. These are countries which are likely to have escaped acute exchange pressure thanks to the euro.

(3) Not a Complete Shield

Exchange rate stability does not mean that each and every euro area member country has been shielded from the Global Crisis. It is too early to determine the full impact of the crisis in terms of income and employment losses. Currently available information suggests that the crisis is most severe in countries that have some autonomous aggravating circumstances. Autonomous reasons to be affected by the global turmoil include house price bubbles that had to burst sooner or later (France, Ireland, Spain and

other countries), bank exposure to US mortgage-backed securities (Belgium, France, Germany) and bank exposure to euro-denominated loans in non-euro area countries (Austria).

These are not wholly autonomous factors. It could even be claimed that, in the absence of the US subprime crisis, nothing would have happened or, at least, not now and not so violently. Indeed, with the exception of house price bubbles that had to burst sooner or later, these were only vulnerabilities. Under lucky circumstances, the risks would not have materialised. The nature of vulnerabilities, however, is not just that they can be the source of adverse effects when circumstances are unfavourable but that they can also trigger self-fulfilling crises.¹ The mere fact that difficulties can arise under plausible circumstances can lead markets to seek protection –or profit– opportunities and bring about the feared outcome.

A potential example is Lehman Brothers, whose vulnerability was its exposure to mortgage-based securities. This investment bank faced a run on its deposits by other banks when rumours –quite possibly ill-intended– spread that it could become bankrupt. Under a more optimistic assessment, Lehman could have escaped disaster, like many other banks did, but negative sentiment transformed an –admittedly large– vulnerability into full-fledged disaster. The 1993 crisis within the European Monetary System (EMS) is another example of self-fulfilling crises. Then, two member currencies, the Italian lira and the pound Sterling, were clearly overvalued. When the respective authorities quickly gave in to speculative pressure and gave up their fixed exchange rate regimes, the markets soon concluded that all EMS currencies were vulnerable and forced several countries to accept a depreciation (Eichengreen *et al.*, 1995).

This time around, within the euro area, a large public debt combined with a sizeable deficit and a politically weak government made Greece vulnerable to negative sentiment. In this case, the markets focused on public debt and the risk of –partial or total– default. This took the form of sharply rising spreads on Greek government debt relative to German debt. In normal times, the spread was around 20-30 basis points. Graph 1 shows that the spread has increased tenfold. In the event, the Greek government has found it difficult to roll over its maturing debt. Italy and Portugal faced a similar situation.

A similar quasi-panic affected Ireland. In 2007, at 25% of GDP, Irish public debt was actually low by international standards. Its vulnerability was in the size of the house price bubble. Numerous households were suffering from very large losses as the bubble burst and this was exposing many Irish banks to a large volume of non-performing loans. The markets reasoned that the government would have to bail out distressed banks and that the economy would undergo a deep recession, further swelling the budget deficit. As

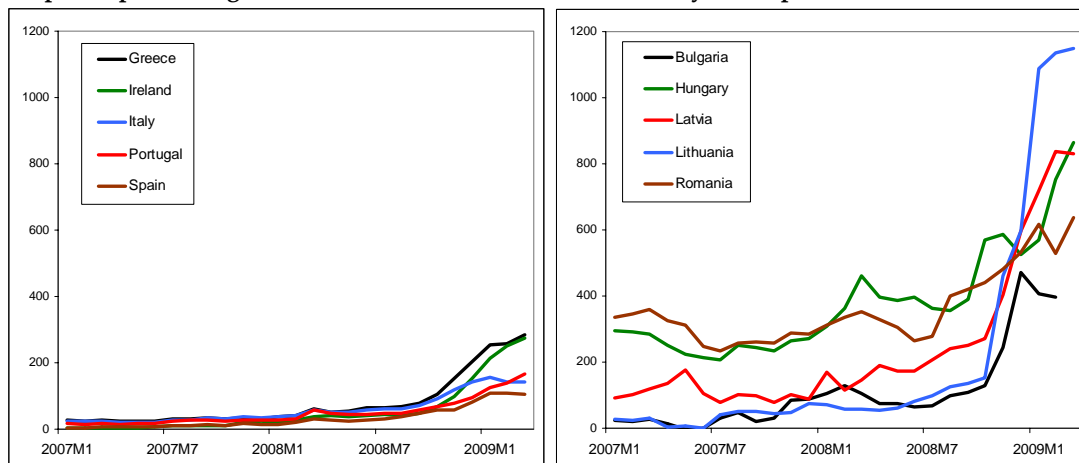
¹ The role of vulnerabilities in triggering crises is established in Krugman (1996).

Graph 1 shows, the spread also rose to close to 300 basis points. Spain was in a nearly identical situation.

Some commentators were so alarmed at the size of these spreads that they suggested that this was the beginning of the euro area's break-up. For instance, Feldstein (2008), a long-time euro-sceptic, wrote:

'The current differences in the interest rates of euro-zone government bonds show that the financial markets regard a breakup as a real possibility. [...] There have, of course, been many examples in history in which currency unions or single-currency states have broken up. Although there are technical and legal reasons why such a split would be harder for an EMU country, there seems little doubt that a country could withdraw if it really wanted to'.

Graph 1. Spreads of government bond rates relative to Germany (basis points)



Source: *International Financial Statistics*, IMF.

The 'break-uppers' advance several arguments. The main one is that asymmetric disturbances make the cost of giving up national monetary policies prohibitively high. Other arguments concern the sharp disagreements within the euro area and the political expediency of papering over these disagreements. The definitive answer by Eichengreen (2009) is that leaving the euro area is bound to be far too costly for any rational government to do it.

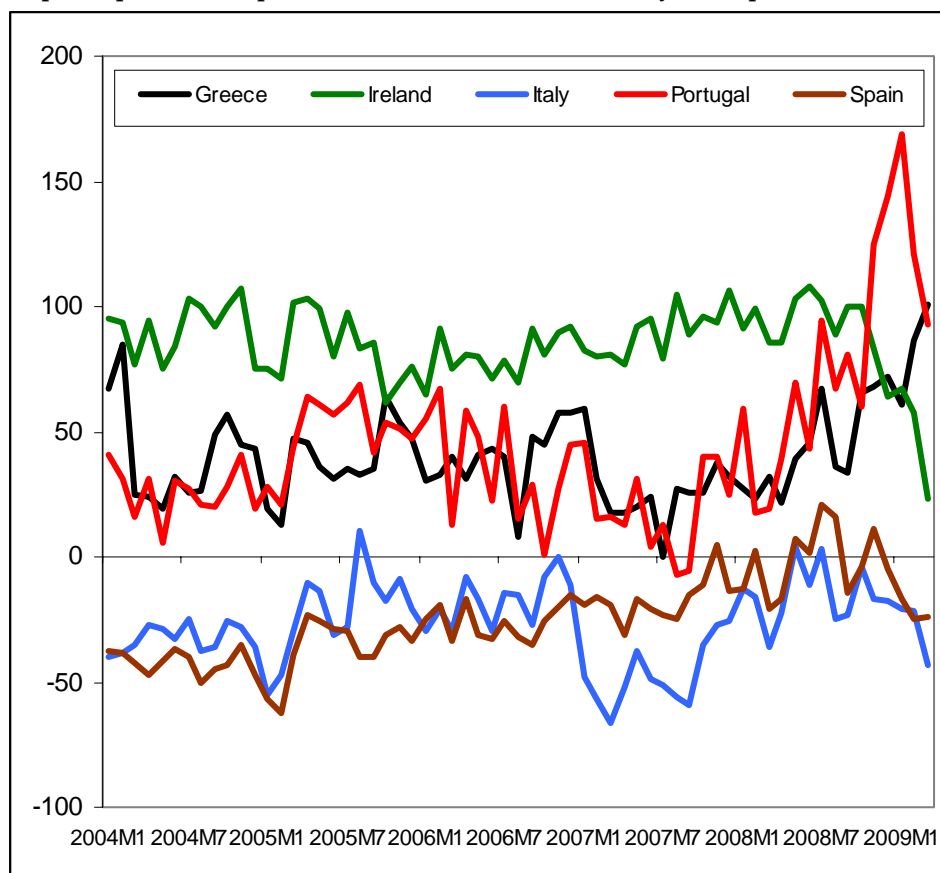
Yet the 'break-uppers' note that the rise of spreads can be seen as an indication that the likelihood that some countries leave the euro area is no longer negligible. Indeed, the spread may not represent the probability of debt default, or not only: it could also include the probability of a future depreciation, which would lead to higher interest rates built into the yield curve. If that were the curve, this should also affect lending rates to the private sector. Interest rates charged by banks on large loans to corporations are shown in Graph 2. These are spreads relative to loans in Germany for the same five countries as in Graph 1. With the temporary exception of Portugal, there is no indication that the spreads



on private loans increased when those on government bonds did. This evidence suggests that the spectacular increase in bond spreads reflects concern about public debt service and not about any potential exit from the euro area.

In the end, the single currency did what it was expected to do, namely remove the spectre of speculative attacks on national currencies. It did not do any miracle that it was not expected to do, like protecting heavy borrowers from market suspicion –most likely unjustified– during a historic crisis marked by a huge increase in perceived risk that led to a flight to quality. Here again, the most important observation is not what we saw but did not happen. So far at least, no government has been unable to refinance its maturing debt or to finance new debt. There have been a few worrying signals, but no pressing default threat. It may be that a relatively mild outcome is a response to suggestions by policymakers that they had –unspecified– contingency plans to deal with such a situation. It could have been a bluff; if so, this time it worked.

Graph 2. Spreads of corporate bond rates relative to Germany (basis points)



Note: lending rates on large loans to corporations.

Source: *International Financial Statistics*, IMF.

(4) The Price of Non-euro Area Membership

Even if bond spreads are large enough to alarm observers, they pale in comparison to those seen in several non-euro area countries that are EU members. They are shown on the right-hand chart in Graph 1. The benefits of euro area membership can be read negatively by looking at the situation in some EU countries. The spreads there reflect the intensity of the crisis that has forced some countries (Hungary and Latvia) to apply to the IMF for emergency support.

Even countries whose currencies are tied to the euro *via* a currency board arrangement (Bulgaria and Lithuania) experienced spreads of a different order of magnitude to those found in the euro area. In fact, these two countries did not do better in that dimension than countries with more flexible exchange rate regimes (Hungary, Latvia and Rumania). This experience suggests that currency boards are far from being 'close to' the irreversible elimination of the domestic currency. In fact, the Baltic countries have long been convinced of the fragility of the arrangement and eager to adopt the euro, only to be rebuked by the incumbent countries that insist on a strict application of the Maastricht convergence criteria.² For them, the cost of the crisis has been enormous. The three Baltic States record the biggest drops in real GDP inside the EU, all in the double-digit range.

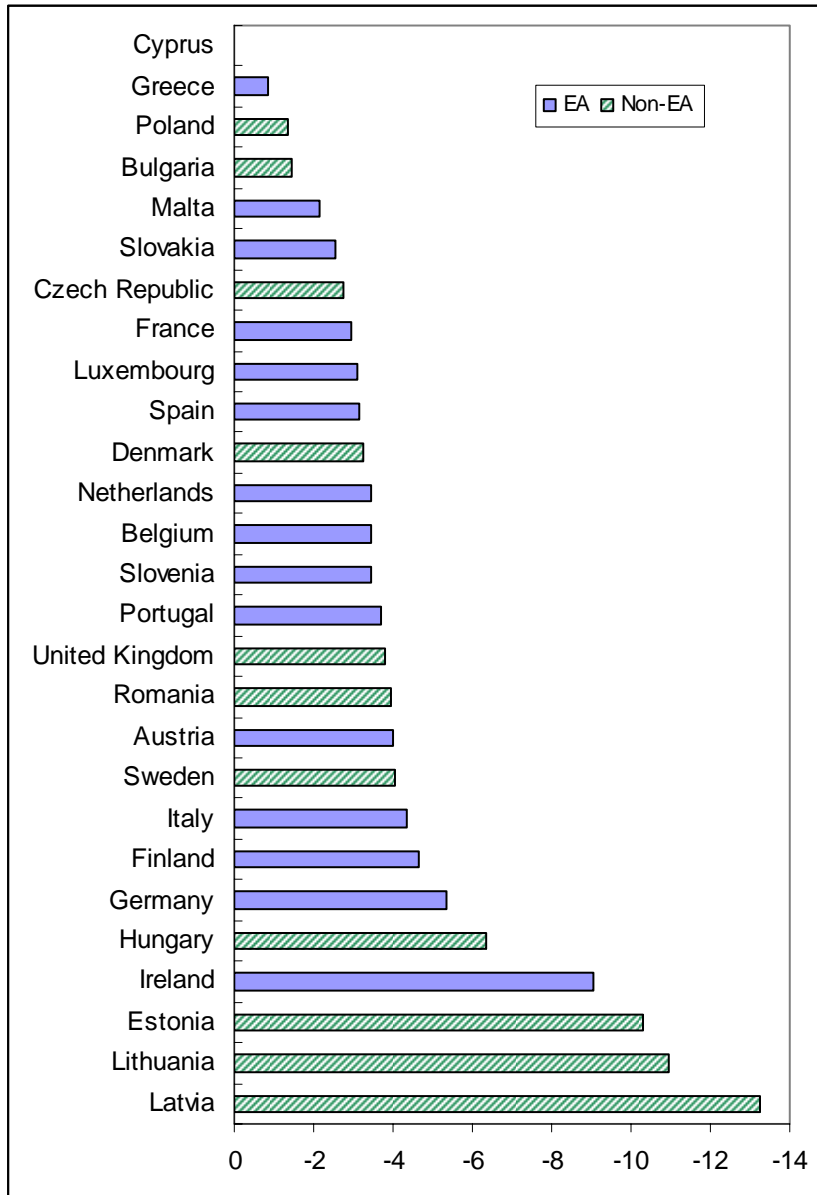
² For a discussion, see Wyplosz (2007).

Graph 3, which uses forecasts from the European Commission, also shows that non-euro area member countries have tended to fare worse than euro area members. Those that did better tend to be countries whose exchange rates underwent deep depreciations, which gave them a competitive boost at a time when demand was generally falling fast.³ This evidence might turn out to be misleading because the crisis is not over and much can still happen. At this stage, it suggests that monetary, and therefore exchange rate policy autonomy, can help in bad times. At such times, the worst arrangement is a fixed exchange rate arrangement that is inferior to both flexibility and monetary union membership. This is in line with the findings of Rogoff *et al.* (2004), based on a large sample of countries over many more years.

³ The relationship is not strong. Bulgaria and Denmark, whose euro exchange rates remained constant, recorded relatively small drops in real GDP.



Graph 3. Growth rates in 2009 (%)



Source: AMECO database, European Commission.

(5) An Unfinished Business

One of the hoped-for effects of the single currency was the emergence of a fully integrated market for financial services. A decade after the creation of the euro, financial integration is an unfinished business and the Global Crisis has helped to reveal the reason: protectionism.

In the immediate aftermath of the creation of the euro, financial integration has become complete in the monetary markets and bond markets. Other markets, including corporate

bond and stock markets, have lagged, as shown by Japelli & Pagano (2008) and ECB (2009). The reasons for limited integration are related to national specificities, including regulation, trading platforms, enforcement legislation and supervision. Why have these specificities been retained? Largely because many national governments are unwilling to let their national champions (banks, stock markets) be subject to direct competition. For instance, specific national regulations operate as a barrier to entry.

The lack of complete financial integration is likely to reduce the benefits from the single currency but these benefits might not be very substantial.⁴ More important, probably, are the potential side effects of some of these protectionist measures. In particular, the crisis has exposed the dangers of continuing to rely on national regulation and supervision when banks have started to operate on a larger scale than individual countries.

The risks had long been identified, for example by Begg *et al.* (1998), even before the launch of the single currency. When a bank operates in several countries, or is owned by residents from different countries, the situation can become complicated if it is about to fail. There is potentially more than one lender in last resort, which means that the costs of a bailout are bound to be shared by several Treasuries and their respective taxpayers. The costs of a failure are also bound to affect depositors in several countries. In theory, a fair deal could be arranged, but there many reasons to make it impossible. First, the true situation of the bank is not known, because many supervisors have each got only partial information. The agreed principle is that national supervisors truthfully share their information, but this is unlikely. Indeed, each supervisor will want to minimise the costs to be borne by his own country. In addition, each country is concerned about protecting its own banks. Crucially, decisions must be made in a matter of days, if not hours; this leaves insufficient time for sharing and analysing the amount of information required to pass judgment on the situation.

An example of this situation is the collapse of Bank Fortis, owned by Belgian, Dutch and French investors. A decision on bailing it out had to be made over a weekend to avoid a run by depositors on the following Monday. This involved difficult negotiations between the three governments and led to a decision that was subsequently challenged by some shareholders, who could play one government against the others.

Following this, the authorities could no longer keep ignoring the problem. This triggered the preparation of the Larosière report. The report (Larosière, 2009) did not go as far as proposing the logical solution: a single EU supervisor and a single EU regulator. This is what Begg *et al.* (1998) had proposed and this is what the Vice President of the ECB, Lucas Papademos (2009), seemed to have in mind:

⁴ Gourinchas & Jeanne (2004) and Kose *et al.* (2004) present convincing evidence that the gains from financial integration are limited.

‘The regulatory framework and the supervisory arrangements in Europe must be broadly compatible with those in other large economic areas, notably the United States and vice versa. And within the EU, the growing presence and significance of cross-border financial institutions (the largest 43 cross-border banking groups in the EU accounted for 76 % of total EU bank assets at the end of 2007) requires the strengthening of the pan-European character of supervision’.

Instead, Larosière (2009) proposed to keep the current structure of national regulators and supervisors but to create two supranational bodies, the European System of Financial Supervision and the European Systemic Risk Council that would cooperate with national supervisors and the ECB. This is clearly a compromise between what is desirable and what is possible. Even this compromise might well be watered down to remove any transfer of sovereignty to these bodies. The same reasons that led the authorities to ignore the dangers of cross-border banking without adequate cross-border regulation and supervision –protection of national banks–, along with intense lobbying by national regulators and supervisors to retain their prerogatives, are prevailing one more time.

Beyond turf battles, EU-wide regulation and supervision is also hampered by deep philosophical or ideological disagreements. To simplify somewhat, the debate is between the UK and the two large continental countries, France and Germany, that have traditionally led the integration process. The UK is home to Europe’s largest financial centre. The City of London has established its prominence on the basis of a ‘light touch’ approach to regulation. Even though the City and British banks have suffered massive losses, the authorities are keen to preserve a sector that contributes heavily to the British economy. France and Germany harbour little admiration for ‘Anglo-Saxon’ finance and have traditionally favoured strict regulation. Even though the French and German supervisors have failed to exercise their authority, which has led to massive losses in German banks, they see the crisis as a vindication of their views and an indictment of the British approach. The UK authorities are therefore adamant that they want to keep full control of regulation and supervision in their own country, especially as they suspect, quite reasonably, that the French and German authorities are trying to use the crisis as a pretext to cut the City of London down to size. This is one key reason why the proposals of the Larosière report are unlikely to be accepted as formulated.

Still, having stood at the edge of the abyss, the national political authorities understand that something must be done. If significant parts of the Larosière report end up being implemented, a new machinery will be in place. Over time, its natural tendency will be to shift national authority to the EU level. Its existence will also prevent the overlooking of a large missing element of European financial integration.

(6) Lack of Coordination?

Regarding macroeconomic policies, the euro area has a common monetary policy while fiscal policies remain a matter of national prerogative, even though they are subject to the Stability and Growth Pact. Over the first 10 years of its existence, the ECB has achieved an impressive track record. Since WWII never has inflation been so low for so long, even in Germany. The ECB has reacted promptly to the onset of crisis by providing massive liquidity to banks as their normal channel of refinancing, the interbank market, seized up. The ECB has also appropriately lowered the policy interest rate, even though some observers consider that it has done so reluctantly and belatedly. At any rate, the ECB has established itself as a truly pan-European institution and as a fiercely independent central bank. It has resisted government pressure. It has distanced itself from ideologically-driven schools of thought. It has shown itself more pragmatic than its discourse suggests. As far as monetary policy is concerned, the euro area is well equipped, in bad as in good times.

Concerning fiscal policy, the situation is considerably less clear. On the one hand, fiscal policy becomes the only instrument left to deal with macroeconomic disturbances. On the other hand, one country's fiscal policy stands to affect other countries, so there might be a common interest in coordinating actions. Coordination is not a loss of sovereignty, but it still implies a reduction in the room for manoeuvre. The crisis has shown both the desirability of coordination and the difficulties of doing so.

A good example is the contrast between Ireland and Germany, the two countries that are expected to suffer the worst recession in 2009 within the euro area, as shown in

Graph 3. Ireland has been especially hard hit because this is where the housing boom had been most spectacular. Germany suffered because of its dependence on manufacturing exports, which fell sharply in the midst of the sharp decline in global industrial production. Before the crisis, in 2007, Ireland's public debt of 25% of GDP was less than half that of Germany, at 65% of GDP. Ireland therefore had much leeway to use fiscal policy to alleviate the impact of the housing market collapse. The German government had just managed to stabilise its debt and was committed to reduce it when the crisis struck. But Ireland is a very open economy, so any fiscal expansion is bound to have limited domestic effects as additional spending largely falls on imports and therefore does not support much domestic income and level of activity. Germany too is quite open, but much less than Ireland, so fiscal policy can have more traction. In addition, given its size, Germany's fiscal policy affects the smaller open economies in Europe. Given this situation, it was in both Ireland's and Germany's interest that both countries undertake strong fiscal expansions. It did not happen. Germany ended up expanding its fiscal policy but with considerable reluctance and with a focus on actions that favour its domestic market: too little and too late to prevent its worst recession in post-war history. Ireland did not expand either but its budget deficit nevertheless exploded as the economy folded. This example, which applies to other euro area member countries as well, illustrates the benefits to be gained from fiscal policy coordination. The absence of such coordination when it was most needed indicates that something is missing in the European construction. The European Commission did try to trigger the process, proposing a €200 billion joint expenditure programme. Its proposal did not have the hoped-for effect, nor did other calls for joint action. Most countries reasoned that a fiscal expansion would bring limited domestic benefits but impose large costs in the form of permanently increased public indebtedness. Every country concluded that the best fiscal expansion was that enacted by its partners: all benefits and no costs. This free-riding pattern is a classic argument in favour of coordination. In fact, from the beginning of the monetary union, some countries, especially France, have defended the view that Europe needs an 'economic government'. This view has remained a minority view for several reasons.

First, in the initial proposal, the 'economic government of Europe' was meant as a counterpart to the ECB, a thinly disguised effort at curbing the central bank's room for manoeuvre. For most countries, including Germany, central bank independence is a fundamental characteristic that can never be challenged. Renewed proposals for an 'economic government' tried to distance themselves from the issue of central bank independence but they cannot remove the suspicion initially created.

Secondly, there are deep disagreements about the effectiveness of fiscal policy. The theoretical and empirical literature has failed to reach a consensus. Governments are also split on the issue. The traditional German view, for instance, is that fiscal policy is not really effective and often ill-timed. A resolution of these disagreements is to accept that the automatic stabilisers might be helpful but to shun discretionary action. This is the

view that prevailed at the beginning of the crisis and that has been shaken as the depth of the recession has become visible.

Third, in every country fiscal policy is a prerogative shared by the government and the parliament. Any restriction on policy decisions would constrain government and parliament. There is little appetite in these institutions for accepting a limit to their power in a domain that is heavily politicised because it is inherently designed to redistribute income. The different sets of policy actions adopted during the crisis well illustrate that economic rationality does not prevail.

Fourth, in normal times, the benefits of coordination are likely to be low because monetary policy can deal with symmetric shocks. Given the heavy political costs of coordination, there is little scope for any formal mechanism. The crisis has shown that there are times when this reasoning does not apply.

Fifth, it is sometimes suggested that the Stability and Growth Pact is the appropriate channel for fiscal policy coordination. This is seriously misleading. The pact prescribes a ceiling for budget deficit (3% of GDP) and public debt that do not exceed 60% of GDP. Its only aim is to encourage fiscal discipline. Member country discipline has been identified in the Maastricht Treaty as a common interest because, historically, high inflation rates have been the consequence of a loss of control of public finances. Thus the pact has not been designed to foster policy coordination but to prevent situations where the ECB would come under pressure to inflate away excessively high public debts or even to finance budget deficits or bail out defaulting governments. In fact, the Maastricht Treaty already bans direct budget financing and debt bailout by the ECB. It also provides the ECB with the highest degree of independence among all central banks. In that sense, the Stability and Growth Pact is not needed. The crisis has shown that it can be counterproductive.

We have seen that Ireland and Germany have not used their fiscal policy instrument decisively enough to soften the blow of the crisis. This is also the case in most other euro area member countries. This surprising quasi-unanimity, which contrasts with more decisive actions elsewhere, is largely a consequence of the Stability and Growth Pact. The pact has been suspended in accordance with an escape clause that concerns serious recessions, but policymakers know that it will come back into force once the situation improves. Most governments have tried to limit the deficits that have soared as a consequence of the crisis. As expected, they failed to put a lid on their deficits because they failed to revive their economies, a well-known trap. Remarkably, this occurred in the presence of approximately symmetric shocks, when it is expected that coordination is not needed because governments should spontaneously adopt similar actions. Free-riding and a misplaced concern about deficits are at the root of this misfiring.

A reasonable lesson to draw is that while an ‘economic government for Europe’ is unnecessary in normal times, coordination is highly desirable in bad times. Another lesson is that the Stability and Growth Pact is not a conduit for coordination and might exert a perverse influence on governments. Combining both lessons is another challenge.

One possibility is to rethink the Stability and Growth Pact to make it more symmetric and an incentive to cooperate when needed. The pact is asymmetric in the sense that it aims at limiting deficits, which is desirable in normal times. The pact does not have anything to say when a recession calls for an expansionary fiscal policy, it is simply suspended. There is room for extending the pact to this situation. In exchange for a suspension, governments could be asked to jointly seek a collective response to the shocks they face. Much as it is the agent enforcing discipline in normal times, the European Commission could be the agent promoting concerted fiscal expansion in bad times.

(7) Conclusion

The crisis has demonstrated both the usefulness of a monetary union and its limits. The eradication of speculative attacks on national currencies is a major achievement. The independent ECB has responded quickly and effectively to the financial crisis, although a bit more slowly and less decisively to the ensuing recession. Overall, euro area member countries have been protected from some of the worst consequences of the crisis. At the same time, the single currency has not prevented the crisis from selectively affecting euro area countries with vulnerabilities. This is as it should be. Market discipline does not stop with the adoption of a common currency. The strength of the euro reflects the quality of monetary policy conducted by the independent ECB. Governments perceived by the markets as fiscally undisciplined, or highly exposed to bank bailouts, have faced sharply rising interest rates on their debt instruments. The pressure is healthy if the markets correctly evaluate the situation.

The crisis has also served as a magnifying lens, bringing up facts that were not subject to much scrutiny beforehand. The treatment of countries that joined the EU in 2004 is one case of negligence by the incumbent members of the euro area. The insistence on a strict application of the Maastricht Treaty entry conditions is keeping out of the euro area a number of countries, many of which have been under extraordinary pressure since the beginning of the crisis. For these countries, the marginal benefits from euro area membership have been shown to be considerable. The marginal costs to the rest of the area of admitting them through a flexible interpretation of the treaty have never been spelled out. Once the crisis is over, the perception that the next one is far off is likely to deter any change of heart on the side of the incumbents.

The issue of banking regulation and supervision is another area that has been purposely ignored at the euro area level. The maintenance of national regulators and supervisors is

increasingly incompatible with the continuing integration of financial services and financial markets. While this situation, and other similar regulations, amounts to a form of protectionism, it is not enough to block the emergence of cross-border financial institutions. This, in turn, calls for cross-border regulation and supervision. The collapse of one cross-border bank has made it clear that the *status quo* cannot be maintained. But opposition to the logical solution of euro area level regulation and supervision remains strong and influential. The adjustment process is therefore likely to be incremental.

The euro area governments have been surprisingly timid in adopting expansionary fiscal policies in the face of a historical recession. Part of the reason is the presence of a free-rider problem whereby each country hopes to benefit from fiscal expansions that originate, and are funded, in the other countries. Another reason is the Stability and Growth Pact, which has been suspended but which will come back into force once the recession is over. Free-riding calls for coordination and the pact is not the answer. A full-blown 'economic government for Europe' is not needed and politically not acceptable in normal times but some form of cooperation is called for in bad times, precisely when the pact is suspended. This need has been made very clear during the crisis. Here again, however, progress is bound to be slow –assuming that there is progress–.

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