

Making the Euro Area Fit for the Future

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The crisis in the European currency area is not yet over. Although the situation in the financial markets is currently relatively calm, the economic crisis appears to be bottoming out in most countries. Nevertheless, there are still fundamental design flaws in the Monetary Union. If these are not fully addressed, it will only be a matter of time before a new crisis hits, and a partial or complete breakup of the Monetary Union cannot be ruled out. The economic consequences would be devastating, not least for Germany. To ensure the survival of the European Monetary Union, fundamental reform is required in three problem areas: the financial markets, public finances, and the real economy. In order to give the Monetary Union a stable foundation, all problem areas must be tackled equally; otherwise, due to interactions between these fields, success in one area might be canceled out by a flare-up of the crisis elsewhere.

The present article outlines the elements of such a strategy for the institutional restructuring of the Monetary Union. Other articles in this and the next issue of DIW Economic Bulletin focus on the role of the ECB as the lender of last resort, the banking union and bank regulation, Community bonds, a European investment agenda, migration within the EU, a European unemployment insurance scheme, options for fiscal devaluation, and mechanisms for sovereign bankruptcies.

The euro area is showing signs of gradual economic recovery. However, we should not allow the brighter outlook to disguise the fact that the crisis is not yet over. The situation has definitely improved significantly and the financial markets, too, are more reassured; Ireland and Spain left the European Stability Mechanism (ESM) at the beginning of the year and Portugal soon followed suit. It is likely that the stabilization funds established in recent years and the announcement by the European Central Bank (ECB) that it would intervene to stabilize the financial markets if necessary and under strict conditions has contributed to these positive developments. However, these steps only served to buy time since the root causes of the crisis remain unresolved.

The euro area crisis was rooted in undesirable developments in three problem areas: the banking system, public finances, and the real economy. The crisis became critical primarily because the negative developments in all three areas were mutually reinforcing, which, in turn, triggered a spiral of uncertainty. This is why the resources earmarked for the stabilization of the banking sector in some member states caused government debt to skyrocket. Conversely, in some countries, government bonds lost value as a result of unsustainable growth in debt, which led to imbalances in the banking system. The austerity measures implemented to consolidate debt in some member states placed an enormous burden on the real economy, while the weak economy resulted in a loss of tax revenues, higher welfare spending, and consequently an increase in public budget deficits. As a result of the banking crisis, corporate lending ground to a halt, which led to a decline in investment activity and, in turn, weakened growth. Conversely, weak economic development and plummeting real estate prices ultimately inflated loan defaults to banks and caused credit portfolios to deteriorate. This precipitated a vicious circle in the crisis countries¹ which remains unbroken to this

¹ For a detailed description of the vicious circle of bank debt, sovereign debt, and the macroeconomic crisis, see J. C. Shambaugh, *The Euro's Three*

Box

Abolishing the Euro Would Have Unpredictably High Costs for Germany

It is impossible to put a realistic figure on the cost to Germany of the euro collapsing. What is certain, however, is that it would be a considerable sum. Even an orderly exit from the euro would still see Germany faced with substantial costs, for example, due to the loss of receivables, the appreciation of the deutschmark, exchange rate fluctuations, a weakening of export business, and an increase in unemployment. In the event of a disorderly collapse of the euro area, the cost implications would be even greater.

If each of the individual euro member states were to introduce its own currency, it is highly likely that the new deutschmark would be used by the other countries, not only in the euro area but in the EU, as a reserve currency. Consequently, there would be an appreciation of the deutschmark against the remaining European currencies which, in turn, would reduce Germany's competitiveness. The possible impact on trade mainly depends on the degree of appreciation.¹

As well as the appreciation costs of the deutschmark, there would also be transaction costs from holding foreign currency accounts and buying and selling foreign currency, for example. Exchange rate fluctuations would increase the risks of cross-border trade in goods and services. Further, the price transparency that currently exists across the euro area would be lost, which would have a negative impact on competition.² The slump in trade could be substantial. Baldwin et al. have estimated that the introduction of the common currency led

to an increase in trade within the euro area of between five and ten percent.³

Transferring receivables and liabilities to the respective successor currencies could lead to balance sheet imbalances for both companies and banks. If liabilities denominated in deutschmarks were offset by receivables denominated in another, weaker currency, this would result in a need for recapitalization. Depending on the degree of appreciation, this could trigger corporate collapses and a banking crisis which, in turn, would necessitate extensive government bailout packages and would burden public budgets.

Even the withdrawal of a small country like Greece from the euro would give the markets the sense that the departure of other countries was more likely. This could lead to a domino-like collapse of the entire euro area.⁴ The other crisis countries in the euro area such as Portugal or Italy could be faced with capital flight and possibly bank runs. The ECB payment mechanism would collapse which, in turn, could result in corporate bankruptcies and a slump in investment activity. The refinancing costs for the crisis countries would increase and their public revenue would decline. Ultimately, other countries could be forced to leave the euro in order to avert national insolvency by implementing an expansive national monetary policy. Important trading partners would slide into recession.

It is doubtful that the EU would survive the failure of the euro. If the EU were also to collapse, the benefits of free movement

¹ Due to the different circumstances, the dissolution of other currency unions such as the Soviet Union, Czechoslovakia, or Yugoslavia can only be used for a very limited comparison.

² For a more detailed account of the pros and cons of monetary integration, see also F. Fichtner, *Optimum Currency Area Theory Revisited – New Insights from Stochastic Dynamics* (Aachen: 2008).

³ R. E. Baldwin, J. A. Frankel, and J. Melitz, "The euro's trade effects," ECB Working Paper, no. 0594 (2006).

⁴ A. Åslund, "Why a Breakup of the Euro Area Must Be Avoided: Lessons from Previous Breakups," Policy Brief, no. 12-20 (Peterson Institute for International Economics, 2012).

day. If the situation in any one of the three problem areas were to deteriorate again, due to the reciprocal effects outlined above, the crisis would become critical again.

The possibility of individual member states leaving the Monetary Union or of the euro area dividing—into a

northern and southern euro—are frequent topics of discussion.² However, what is often overlooked is that the dissolution of the euro area would have significant cost implications that are likely to far exceed the anticipated benefits. This not only applies to the crisis countries but also to the more stable economies such as Ger-

Crises (2012), www.brookings.edu/~media/Projects/BPEA/Spring%202012/2012a_Shambaugh.pdf, and Council of Experts (Sachverständigenrat), *Nach dem EU-Gipfel: Zeit für langfristige Lösungen nutzen*, Special Report, July 5, 2012.

² See for example, H.-O. Henkel, *Rettet unser Geld – Wie der Euro-Betrug unseren Wohlstand gefährdet* (Heyne Verlag: 2010); D. Meyer, "Stabilität durch Nord-Süd-Teilung der Währungsunion," *Orientierungen zur Wirtschafts- und Gesellschaftspolitik* 4 (2011): 19-21.

of people, goods, services, and capital would be lost too. Citizens would no longer be able to work and companies would no longer be able to operate unhindered in neighboring countries. Customs duties and different legal systems would put a strain on the trade in goods.

Quantifying the cost to Germany of abolishing the euro is subject to considerable uncertainty. At best, a number can be put on the maximum liability based on TARGET balances and receivables accrued during the implementation of rescue packages; in the event of a dissolution of the European Monetary Union and insolvency of the GIPSIZ states,⁵ this sum would amount to approximately 400 billion euros or 14.5 percent of Germany's GDP.⁶

Two major banks have attempted to quantify the additional costs. In their calculations, both ING⁷ and UBS⁸ assume that national currencies would be reintroduced in an ordered and systematic fashion. The ING calculation is based on the entire euro area collapsing but, at the same time, the EU continuing to exist. Based on this assumption, the estimate puts the financial loss for Germany at approximately 12 percent of the

country's GDP in the first two years.⁹ UBS, on the other hand, has analyzed the impact of Germany withdrawing from the euro and the EU.¹⁰ In this calculation, it is assumed that no other countries leave the euro area as a result of Germany's departure. The UBS estimates costs for Germany of 20 to 25 percent in the first year. Unlike ING's estimate, in addition to one-off costs, the UBS calculation also assumes continuing losses for the following year at ten to 15 percent of Germany's GDP.¹¹

However, both of these studies simulate very specific scenarios and are dependent on the underlying assumptions. Particularly the assumptions underpinning both studies that there is consensus among all countries and that the transition is smooth are very restrictive. Further, estimates on the development of key factors such as exchange rates are fraught with uncertainty.

⁵ Greece, Ireland, Portugal, Spain, Italy, and Cyprus.

⁶ www.cesifo-group.de/de/ifoHome/policy/Haftungspegel.html, accessed on May 7, 2014. The Ifo Institute calculates Germany's existing liability as the sum of outstanding receivables to the Bundesbank resulting from the European Central Bank's payment system (TARGET2 balances), financial assistance paid out to the crisis countries, Germany's share of government bond purchases, and the balance of receivables from issuing the banknotes.

⁷ M. Cliffe, "EMU Break-Up: Pay Now, Pay Later," ING Financial Markets Research (December 1, 2011).

⁸ UBS, "Euro breakup - the consequences," UBS Investment Research - Global Economic Perspectives (2011). This study also analyzes the exit from the euro of an economically-weak country such as Greece but does not quantify the costs for Germany.

⁹ The study actually refers to a three-year period but the first year only includes December 2011 which is the date of the notional collapse of the euro area.

¹⁰ If only Germany were to leave the euro area, the inevitable consequence would also be its departure from the EU. See P. Athanassiou, "Withdrawal and expulsion from the EU and EMU: Some reflections," Legal Working Paper Series (ECB, 2009).

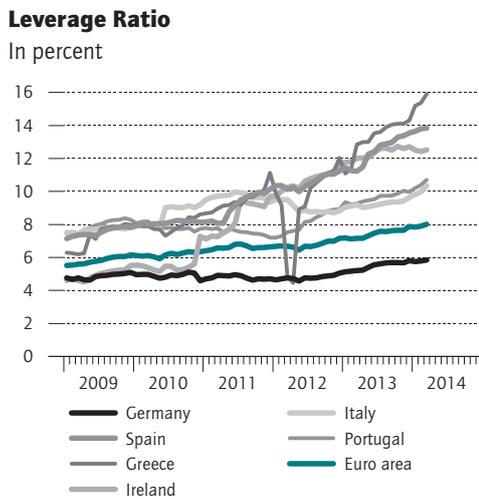
¹¹ UBS estimates the total one-off costs at between 6,000 and 8,000 euros per capita and permanent costs of between 3,500 and 4,500 euros. The percentage shares of GDP are based on the GDP of the study's year of publication.

many (see box). The political fall-out from a collapse of the Monetary Union—and the accompanying dramatic impact on the progress of the European integration process—also mean that ensuring the survival of the common currency must be given the highest priority.

Some institutional reforms have already been implemented in recent years, but they are not enough. With the introduction of joint banking regulation and the harmonization and centralization of resolution procedures, some important structural components of a new finan-

cial market system have been put in place. However, more comprehensive integration is required in order to sever the connection between public finances and the problems of the banking system. Reforms to the Stabil-

Figure 1



Source: ECB.

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The banking sector's debt level has declined considerably since the crisis and equity capital ratios are on the rise.

ity and Growth Pact³ and the Fiscal Pact⁴ implemented as part of fiscal policy could contribute to improving the sustainability of public finances in the euro area; in the medium term, however, there needs to be far more coordination of budgetary policies in order to prevent undesirable developments. There is also room for improvement as far as the coordination of economic policy is concerned. The procedure for preventing macroeconomic imbalances⁵ and the European Semester⁶ are two instruments that have already been created to coordinate economic policy in the euro area. However, other stabilization mechanisms—such as dismantling migration barriers to promote mobility between countries with higher and lower unemployment—have, thus far, only been utilized to a limited extent.

3 In March 2011, a tightening of the Stability and Growth Pact was agreed which prescribed stricter sanctions and required the European Council to provide justification if no sanction process were implemented in the event of an infringement.

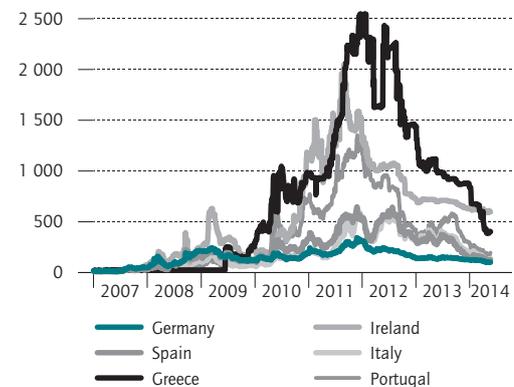
4 The European Fiscal Pact, which was adopted in December 2011, stipulates automatic sanctions for member states of the euro area should they violate any of the financial policy regulations contained in the Maastricht Treaty.

5 The aim of the Macroeconomic Imbalance Procedure (MIP), which was adopted in December 2011, is to help recognize potential risk developments such as significant current account imbalances, house price bubbles, or high public debt in good time and to counteract them.

6 The European Semester, which was adopted in December 2011, requires an assessment of national governments' economic and fiscal policy programs to be implemented before they are adopted by member states.

Figure 2

Credit Default Swaps in the Banking Sector



Source: Datastream.

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European banks' default premiums continue to converge.

Financial Markets: Preventing Systemic Crises

Both the European banking sector and the financial markets in the euro area appear to have stabilized. To a great extent, this is a result of the ECB implementing unconventional monetary policy measures, including longer-term refinancing operations⁷ (LTRO)⁸ and Outright Monetary Transaction⁹ (OMT) programs, which ended the spiral of rising interest rates and negative expectations.

Further, prompted by increased regulatory pressure, banks have also begun to consolidate their balance sheets. Thus, the debt-to-equity or leverage ratio¹⁰ in the euro area has increased from an average of 5.5 percent in 2008 to approximately eight percent today (see

7 In December 2011, as well as introducing *main refinancing operations* (MRO) with a one-week maturity, the ECB also launched its longer-term refinancing operations (LTRO) with a maturity of up to three years. Unlike the main refinancing operations, the purpose of this instrument is not to control short-term interest rates but to provide the finance sector with liquidity.

8 D. G. M. Lenza, H. Pill, and L. Reichlin, "The ECB and the interbank market," ECB Working Paper Series, no. 1496 (2012).

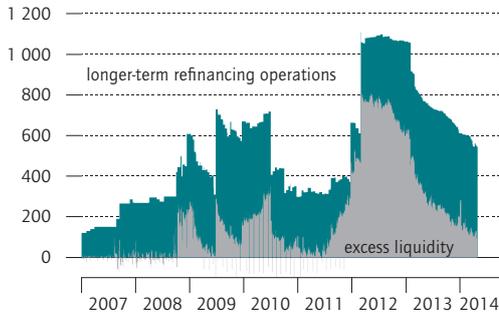
9 The Outright Monetary Transactions (OMT) program, introduced by the ECB in September 2012, allows the Eurosystem to purchase the government bonds of member countries in the secondary market. The aim of the program is to reduce governments' refinancing costs.

10 The *leverage ratio* is a measure of debt levels of the banking sector and is calculated as the ratio of equity capital to non-risk-weighted total assets. For more details about the advantages of a non-risk-weighted measuring system such as the *leverage ratio*, see D. Schäfer, "Banken: Leverage Ratio ist das bessere Risikomaß," DIW Wochenbericht, no. 46 (2011).

Figure 3

Longer-Term Refinancing Operations and Excess Liquidity

In billions of euros



Source: ECB; calculations by DIW Berlin.

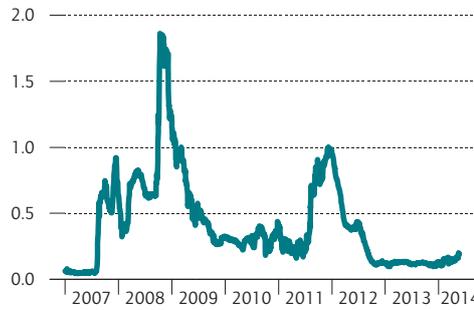
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The ECB significantly reduced excess liquidity in the recent refinancing of the banks.

Figure 4

Interbank Market Risk Premium

In percent



Source: Datastream.

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The risk premium has almost been at its pre-crisis level for more than a year now.

Figure 1). This indicates a certain amount of deleveraging in the banking sector. Also, measured against capital adequacy requirements, it is evident that the situation has improved: very few banks remain below the (currently specified) weighted core capital ratio. Similarly, aggregated credit risk in the euro area's banking sectors has also declined across the board (see Figure 2).

A good indication that confidence has been restored in the interbank market is the early repayment of a significant portion of the ECB's longer-term refinancing operations with a maturity of three years from 2013, which has led to a rapid reduction in banks' excess liquidity (see Figure 3). Money market interest rates have developed in a similarly positive direction, particularly the normalization of risk premiums on the interbank market (see Figure 4).¹¹

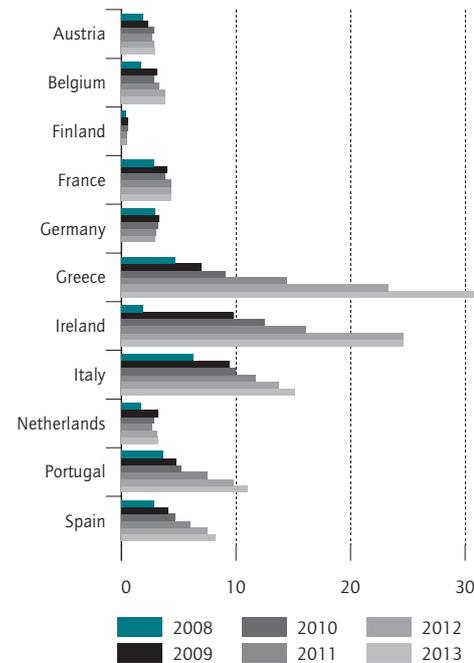
However, the steady rise in the share of loans at risk of default on banks' balance sheets has muddied the waters somewhat and is evidence of the latent risks that remain in the banking sector (see Figure 5).

The stress tests currently being conducted by the European Banking Authority (EBA) and the ECB, which use significantly more stringent criteria than similar tests

Figure 5

Non-Performing Loans

In percent



Source: World Bank.

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The share of non-performing loans has been increasing steadily since 2008.

¹¹ The EURIBOR is the rate at which liquidity is lent on the interbank market at fixed maturities, whereas the EONIA swap rate is the effective overnight interest rate on the interbank market. Since the maturities are not the same, the difference between the two rates is considered a measure of the interbank market risk premium.

conducted in the past, enable us to take a closer look at the stability of the euro area's largest banks. Regardless of the results of the stress tests, the recently adopted recovery and resolution mechanism for ailing banks must first prove itself in practice. The shadow banking sector also remains under-regulated. If appropriate regulations are not implemented, the risks will shift from regulated business segments to the unregulated sector.

European policy has already made significant progress toward a more stable integration of the financial markets by creating a joint banking regulatory authority and harmonizing and centralizing resolution processes. It is questionable, however, whether these new institutional mechanisms are actually robust enough to resolve large failing banks. The main danger is that the size of the planned resolution fund (around 55 billion euros) would not suffice in the event of a systemic banking crisis, in which case financial institutions would have to be shored up by the individual member states again. Further reforms are therefore necessary to completely break the vicious circle between banks and governments. There is also still room for improvement of the regulatory reforms implemented in recent years, such as Basel III¹² or macroprudential regulation, which is discussed in detail in the separate article on the banking union and bank regulation in this issue of DIW Economic Bulletin.¹³

The further development of the banking union is likely to improve the stability of the European banking system. Nonetheless, future banking crises in the euro area and therefore new downward spirals of liquidity issues, credit crunches, deteriorating public finances, and weak real economic development can certainly not be ruled out. One of the main problems during the crisis was the shortage of safe bonds, primarily due to government solvency problems, that could have been used as collateral for securing loans on the European financial markets. It would therefore make sense to generate safe bonds in the euro area to fulfil this purpose in the event of future crises. Suitable instruments have already been proposed which function entirely without joint liability.¹⁴ Suitable types of Eurobond should also be impartially reconsidered as long as they are not used for the "communitarization" of sovereign debt but rather to create liquid markets. The separate article on Com-

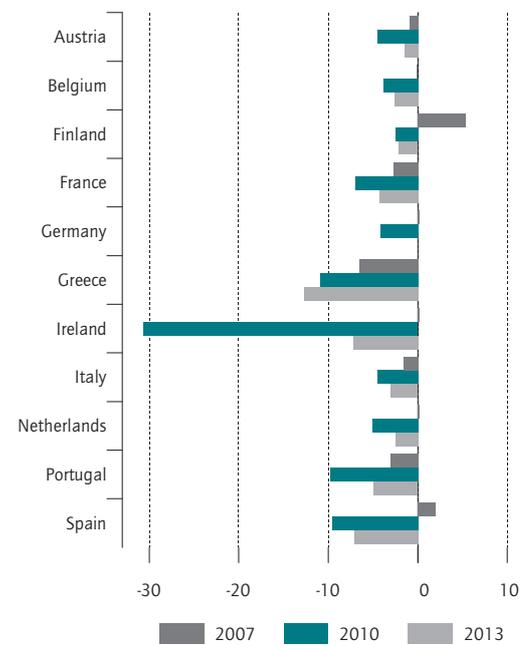
¹² Basel III is a banking regulation reform package published by the Basel Committee on Banking Supervision at the Bank for International Settlements at the end of 2010. See DIW glossary: Basel III, www.diw.de/de/diw_01.c.413274.de/presse/diw_glossar/basel_iii.html.

¹³ An overview of all articles to be published as part of this series can be found at the end of this report.

¹⁴ Brunnermeier et al. European Safe Bonds: ESBies, www.euro-nomics.com (2011)

Figure 6

Public Budget Deficit
As percentage of GDP



Source: Eurostat.

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The average weighted public budget deficit in the euro area has reached almost three percent again.

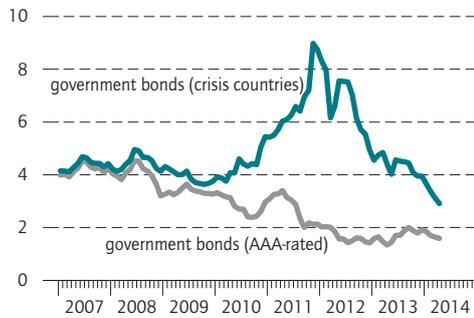
munity bonds in the present DIW Economic Bulletin series outlines the various possible instruments of this type and discusses the pros and cons.

Further, the role of the European Central Bank as the "lender of last resort" also needs to be strengthened. As with central banks around the world, the ECB should have access to explicit fiscal backing that enables it to fulfil its mandate of securing price stability regardless of losses incurred during its operations. Additionally, the role of the European Stability Mechanism (ESM) as a lender of last resort for governments should be strengthened as well. To date, with the announcement of its OMT program, the ECB has undertaken this task. However, the German constitutional court case against the OMT has shown how controversial the ECB's role and the clear definition of its mandate can be. The ECB and ESM's tasks and mandate must therefore be defined more precisely, ideally by way of supplements to the relevant treaties. The prohibition on monetary government financing (Article 123 of the Treaty on the Functioning of the European Union, TFEU) must be confirmed and strengthened. At the same time, the ECB's fiscal backing must be explicitly established. Otherwise, the ECB

Figure 7

Capital Market Interest

In percent



Source: Datastream.

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The interest on government bonds in the crisis countries has fallen to almost the same level as countries with a better credit rating.

runs the risk of not being able to react credibly enough in future crisis situations to fulfil its mandate of maintaining price stability. The separate article on the ECB as the lender of last resort in the present DIW Economic Bulletin discusses this subject in detail.

Public Finances: Ensuring Sound Budgetary Policies

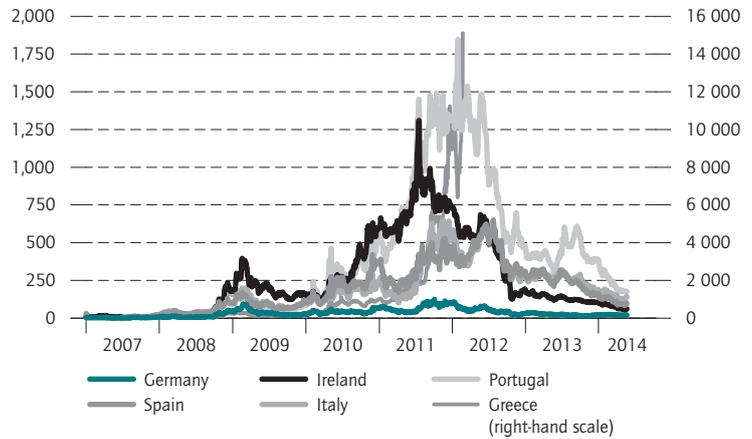
Public sector debt levels remain high in many of the Monetary Union’s economies. Nevertheless, efforts to consolidate them are having some effect: the average public budget deficit in the euro area decreased from 3.7 percent of GDP in 2012 to 3.1 percent in 2013—although there is substantial regional variance (see Figure 6). At the same time, the financing conditions for the crisis countries have been relaxed considerably. Current secondary market yields in Spain, Italy, Portugal, Greece, and Ireland are around three percent, which is not even half the peak level reached during the sovereign debt crisis (see Figure 7). The development of credit default swaps (CDS) also illustrates an easing of the situation on the European government bond markets (see Figure 8).

However, the main reason for this improvement is probably the use of unconventional monetary policy measures, particularly the ECB’s OMT program.¹⁵ By announcing

¹⁵ D. Zsolt, “The Euro Crisis: Ten Roots, but Fewer Solutions,” Bruegel Policy Contribution 17 (2012): particularly 17.

Figure 8

Government Bond Credit Default Swaps



Source: Datastream.

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The markets’ default risk rating of government bonds has significantly improved again in the crisis countries.

that it would intervene to create stability on the secondary government bonds market, if necessary and under strict conditions, the ECB successfully eased the markets’ uncertainty relating to crisis countries defaulting on their debt repayments. However, the markets’ risk assessment is unlikely to stand up to an objective evaluation of its framework conditions; a sustainable solution for the problems on the markets for government bonds thus remains elusive.

Despite the fact that deficits have been significantly reduced in some countries, public debt levels have increased again and continue to limit scope for fiscal maneuver in the Monetary Union (see Figure 9); it is likely that this would become all the more important should financing conditions deteriorate again and the interest burden increase.¹⁶ In addition, the low inflation rate in the Monetary Union (currently around one percent) only makes a marginal contribution to reducing the debt burden.¹⁷

Further, the danger that member states of the Monetary Union will again experience unsustainable debt developments in the future has not yet been averted. In

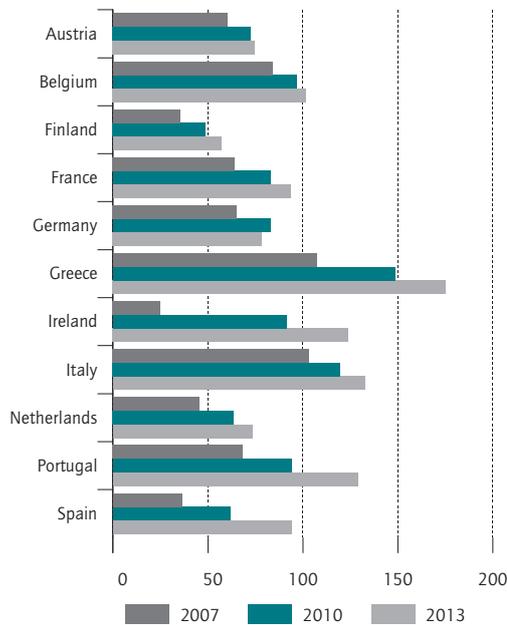
¹⁶ M. Krokert, D. Schäfer, and A. Stephan, “Mit niedrigen Zinsen aus der Schuldenfalle,” DIW Wochenbericht, no. 7 (2014): 115-126.

¹⁷ K. Bernoth, M. Fratzscher, and P. König, “Weak Inflation and Threat of Deflation in the Euro Area: Limits of Conventional Monetary Policy,” DIW Economic Bulletin, no. 5 (2014).

Figure 9

Sovereign Debt

As percentage of GDP



Source: Eurostat.

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Despite falling deficits, sovereign debt is continuing to climb.

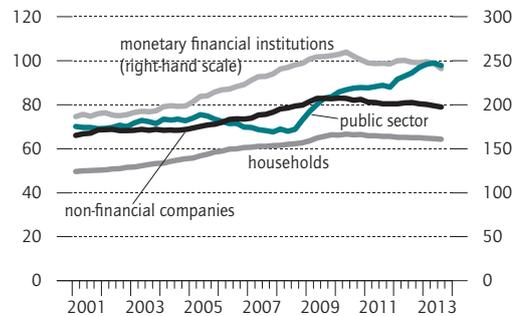
the past, it has not been possible to persuade national governments to follow responsible spending and debt policies, whether by way of regulation or market incentives. Therefore, the previous version of the Stability and Growth Pact did not meet expectations. The disciplining effect of the financial markets also had limited impact since creditors barely differentiated between member states of the Monetary Union when they were fixing interest rates—probably also because the Maastricht Treaty’s no-bailout clause was not credible.

To achieve sustainable fiscal policies, regulations tying fiscal policy with the reforms of the Stability and Growth Pact and the anchoring of debt brakes in national legislation of member states (fiscal pact) have been strengthened in recent years; it remains to be seen whether the new regulations—such as possible sanctions for infringements—will be rigorously implemented, however. Unfortunately experience of the old Stability and Growth Pact casts doubt on that supposition. This applies all the more given that, to date, no provisions have been made to curb excessive debt policy more effectively using market-based sanction mechanisms. The financial markets in particular have no real reason to view the no-bailout clause as significantly more

Figure 10

Debt Levels

As percentage of GDP



Sources: EEA/ECB, taken from P. Cour-Thimann and B. Winkler, “The ECB’s non-standard monetary policy measures: the role of institutional factors and financial structure,” *Oxford Review of Economic Policy*, 28 (4) (2013): 765–803 and updated.

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Recently, debt levels in the private sector have been slightly lower.

credible than before the crisis. On the one hand, experience in Greece and Cyprus has shown that European government bonds cannot always be seen as default risk-free. In addition, international financial institutions increasingly perceive preventative bail-ins as a legitimate instrument during debt crises.¹⁸ On the other hand, the stabilization funds established in recent years and the bond program announced by the ECB have tended to heighten the expectation that, in the event of individual member states running into financial difficulties, debt default is only likely to occur in exceptional circumstances. Consequently, the debt development of individual member states will probably only have a marginal impact on risk premiums in the future, thus rendering their disciplining effect inadequate. This is only likely to change if debt default becomes a credible prospect in the euro area. As the separate report in this series on mechanisms for state insolvency demonstrates, the option of controlled debt reduction as part of an insolvency process for overindebted Monetary Union member states could also make a contribution here; in this context, the much-vaunted introduction of collective action

¹⁸ IMF, *Sovereign Debt Restructuring—Recent Developments and Implications for the Fund’s Legal and Policy Framework* (2013), www.imf.org/external/np/pp/eng/2013/042613.pdf.

clauses¹⁹ is only the first step and, moreover, their effectiveness is not without its detractors.²⁰

There is also room for improvement as far as the coordination of fiscal policy in the Monetary Union is concerned. Since monetary policy is not available as a stabilization mechanism in the event of divergent economic developments in the individual member states, and the exchange rate ceases to be an adjustment tool, fiscal policy is a hugely important instrument for stabilizing the Monetary Union's economy. Against this backdrop, the creation of a "fiscal capacity" is currently under discussion, i.e., an instrument that would be managed at European level and used to absorb macroeconomic shocks (Van Rompuy report).²¹ One possible alternative way of ensuring a higher degree of synchronization of economic cycles in the euro area, and thus facilitating a common monetary policy, would be an automatic transfer system, such as a European unemployment insurance scheme.²² The separate report on European unemployment insurance which is part of this publication series analyzes the organization, feasibility, and benefits of such a scheme.

However, one of the key challenges for fiscal policy remains the reduction of public debt which is still very high. For this to happen, economic development requires a solid foundation; strong growth and an associated improvement in public revenues and expenditure are both decisive conditions for a sustainable improvement in public finances.

Real Economy: Unlocking Growth Potential

Economic performance in Europe has experienced a slight upturn since spring 2013 and the protracted recession that had prevailed for over two years appears to have been overcome. However, against a backdrop of

very high unemployment in some countries, the necessary debt consolidation by companies, households, and the public sector continues to mar medium-term growth prospects.

Private debt in the euro area remains very high. Some progress has certainly been made toward reducing debt in non-financial companies and households and the debt ratios have declined slightly since 2008 (see Figure 10). However, particularly in the crisis countries, debt remains considerably higher than indicated by the most commonly used measures of debt sustainability²³ (see Figure 11). Households and companies are likely to be working on reducing their liabilities for some years to come before they reach a sustainable debt level. This will be at the expense of corporate investment and private consumer demand which, in turn, will negatively impact economic growth for the foreseeable future. Another process having a dampening effect in many countries is the correction of the overcapacity that was accumulated in individual sectors (real estate, for example) in the past.

Thus, for some years now, the euro area's economy has been on a much lower growth path than before the crisis. The European Commission has forecast the euro area's potential economic growth for 2013 and 2014 at slightly over half a percent. Factors contributing to this situation include total factor productivity in the euro area, which has been on a downward trend for many years, and the weak growth of investment activity and labor participation resulting from the crisis (see Figure 12).

At 11.7 percent, the unemployment rate in the euro area in April 2014 was still extremely high, with youth unemployment and the increasing duration of unemployment being particular problem areas: almost one in four young people aged 15 to 24 is unemployed and nearly one-third of those looking for work in the crisis countries has been out of a job for more than two years (see Figure 13).

A fundamental prerequisite for creating the new, export-oriented economic sectors that could constitute a sound basis for economic development in the crisis countries will be for those countries to leverage investment capital and attract foreign investment. This is the only way of establishing sufficient production capacity to meet the changed requirements. In the process, it is

¹⁹ Based on Collective Action Clauses, bond issuance terms, as required for a debt haircut, for instance, can be agreed by the majority of creditors which then renders them binding for all bond creditors. Consequently, the restructuring of government debt cannot be blocked by a minority of creditors, for example. For details on the implementation of these clauses in the euro area, see http://europa.eu/efc/sub_committee/cac/index_en.htm.

²⁰ For a critical analysis of CACs see, for example, A. Gelpern and M. Gulati, "The wonder-clause," *Journal of Comparative Economics*, no. 41 (2) (2013): 367-385.

²¹ H. van Rompuy, *Towards a Genuine Economic and Monetary Union* (2012), www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf.

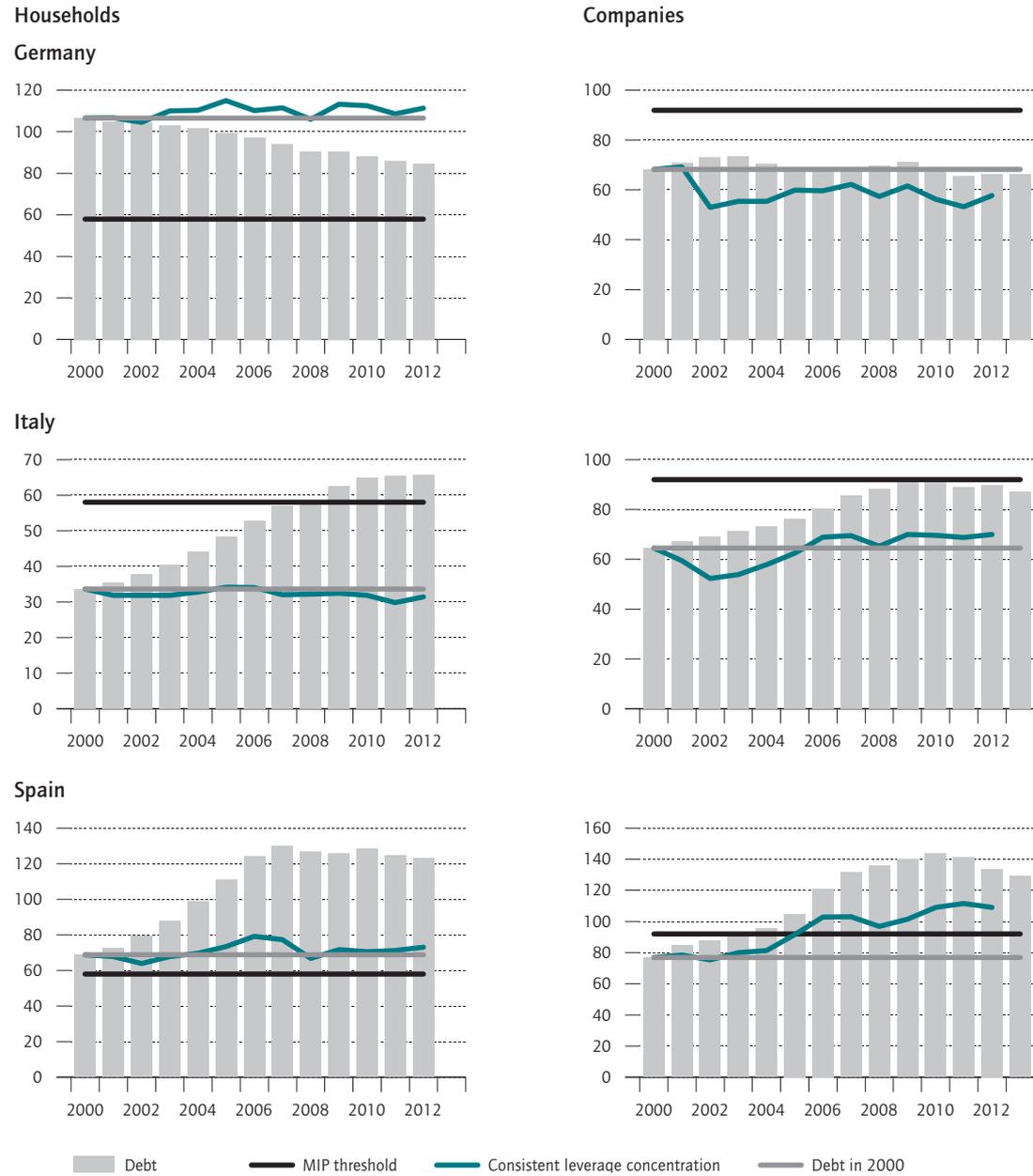
²² On this, see also S. Dullien and F. Fichtner, "Eine gemeinsame Arbeitslosenversicherung für den Euroraum," *DIW Wochenbericht*, no. 44 (2012): 9-15, and, for a more general discussion, K. Bernoth and P. Engler, "A Transfer Mechanism as a Stabilization Tool in the EMU," *DIW Economic Bulletin*, no. 1 (2013): 3-8.

²³ Three conventional threshold values are used here to measure the sustainability of the debt ratio: (1) MIP threshold (threshold according to the criteria of the *Macroeconomic Imbalance Procedure*: debt relative to GDP according to the third quartile of the distribution from 1995 to 2008 for the EU-27), (2) Pre-crisis value (2000), or (3) consistent leverage concentrations, that is, price-adjusted debts develop in parallel with price-adjusted asset values.

Figure 11

Household and Non-Financial Corporate Debt

As percentage of disposable income (households) and percentage of GDP (companies)



Source: Eurostat.

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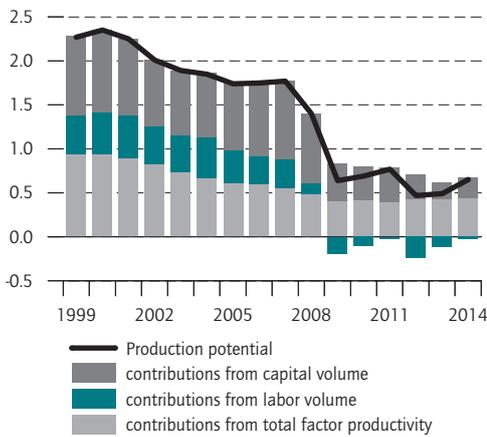
The crisis countries, in particular, have continued to struggle with high debt levels in the private sector.

important to ensure that the inflow of foreign capital is actually spent on investments that will promote growth in the long term rather than repeating the past mistake of investing in branches which had only a short-term positive impact on growth but in the medium term turned

out to be less profitable. The euro area as a whole is also facing a lack of structural investment which is partly linked to the currently high degree of political uncertainty, but also has more deeply-rooted underlying causes. Improvements in financing conditions for investment

Figure 12

Growth Rates of Production Potential in Euro Area
In percent



Source: European Commission (CIRCABC).

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Production potential growth in the euro area has been much slower than before the crisis.

are therefore required; possible options to consider include co-financing infrastructure investment with private and public funds and improving financing options for young innovative enterprises. A separate article in this series on investment in Europe outlines specific strategies for increasing production capacity.

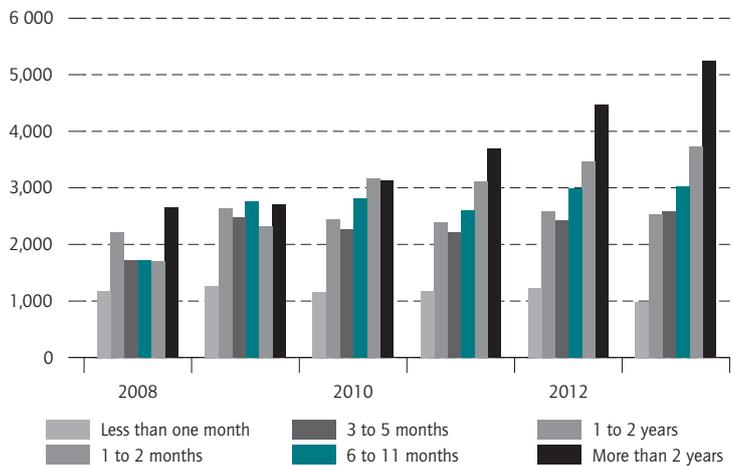
Crisis countries also need to improve their price competitiveness and visible progress has been made in this area in the last few years. For example, in nominal terms, labor costs in many of the crisis countries have barely increased recently compared to other Monetary Union member states, and in some countries they have even decreased significantly (see Figure 14).

One useful way of promoting competitiveness is to restructure the tax system in a revenue-neutral manner, specifically so as to reduce companies' production costs and thus strengthen export activity (fiscal devaluation). This method can also help to counter an increase in future economic imbalances, particularly if corresponding efforts are coordinated across Europe. This proposal is discussed in a separate article on fiscal devaluation as part of this DIW Economic Bulletin series.

The recent increase in mobility within the European Union is one factor which is likely to ease the unemployment situation in the crisis countries somewhat: an in-

Figure 13

Euro Area Unemployment by Duration
In 1,000 people



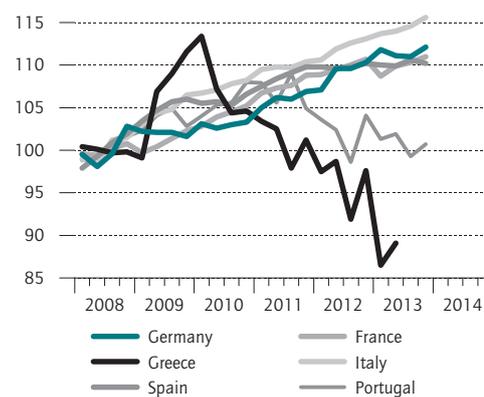
Source: Eurostat.

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The average duration of unemployment has risen sharply.

Figure 14

Nominal Labor Costs
Index (2008=100)



Source: Eurostat.

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Recently, nominal labor costs in Greece and Portugal have declined significantly.

creasing number of people who have no job prospects in the crisis countries are migrating to countries with more favorable economic and employment conditions (for example, to Germany). In order that this stabilization mechanism—which has been discussed in the lit-

erature for decades²⁴—can have more of an impact on Europe in future, the institutional and informal conditions for cross-border mobility within the EU must be further improved. The individual report on migration within the EU in this issue of DIW Economic Bulletin makes various relevant proposals in this area.

Conclusion and Outlook

Beginning in 2008, a vicious cycle of mutually reinforcing crises in the banking system, public finances, and the real economy led to a deep recession with serious political and social ramifications. This triple crisis pushed the project of the century, European integration, to the brink of collapse.

For the time being, the situation has eased somewhat. Public budget deficits in the crisis countries are approaching the three-percent target again although debt levels are continuing to increase in many places. The financial markets have stabilized although the serious ongoing problems faced by European banks and sovereign budgets are predominantly being masked with monetary policy measures. The recession appears to have been weathered yet unemployment rates remain very high in many euro area countries.

The design flaws in the Monetary Union persist. For example, it is still unclear how to resolve major banks without bringing entire economies to their knees. With regard to fiscal policy, here, too, there are ways of encouraging national governments to follow responsible debt policies that have not yet been pursued; clear rules on debt relief for over-indebted countries would be a step in the right direction. When it comes to tackling unemployment, the opportunities created by the increased mobility of workers have not yet been fully utilized; it is imperative that the institutional and informal conditions for migration are further improved. The biggest challenge in the near future will be to generate growth opportunities in the crisis countries, which, first and foremost, requires available investment capital to be used as efficiently as possible and capital stock to be increased in the long term.

In this and the next issue of DIW Economic Bulletin, DIW Berlin makes a series of proposals on reforming the institutional framework of the European Monetary Union with the aim of making it more resistant to future crises (see table). The policy proposals should not be seen as conclusive; for example, in the area of econom-

ic policy coordination, beyond the proposals made here, more can also be done to consolidate economic development in the member states and thus create a basis for a suitable common monetary policy. With regard to the restructuring of the financial markets, here, too, European and international economic policy-makers need to act.

In order to preserve the European Monetary Union, changes to its institutional framework are long overdue. Policy-makers should take advantage of the current phase of relative calm to implement the appropriate reforms. Otherwise, it is only a matter of time before there is a new crisis and a partial or even complete dissolution of the euro area cannot be ruled out. This would bring devastating economic and political consequences—not least for Germany.

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²⁴ R. Mundell, "A Theory of Optimum Currency Areas," *American Economic Review*, vol. 51(4) (1961): 657-665.

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