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## **MONETARY AND FISCAL POLICY COORDINATION AS AN ANTICRISIS METHOD IN EURO AREA**

Abstract: The main goal of this article is to find an answer for the question about necessary reform to be undertaken in the EU to save the euro as a common currency. Author envisages the institutional reforms in the euro area before further enlargement to the new member countries from east and central Europe. The essential element of the reform is to establish a proper mix between the ECB' monetary policy and fiscal policies in the member states. All proposed steps against euro crisis are mutually correlated: monetary integration requires stricter fiscal integration, fiscal integration requires banking union but banking union is going to require some form of a political union. This way the debt crisis in the euro area may present an opportunity to renew the strength of European institutions.

### Introduction

Financial crisis have been pervasive phenomenon throughout history. Bordo et al. ( 2001 ) found that their frequency in recent decades has been doubled that of the Bretton Wood period. Although the actual financial crisis started in 2008 and was initially seen as difficulties in the US subprime mortgage market, rapidly escalated and spilled over to financial market all over the world. It touched deeply the members of euro area and changed into economic depression with growing unemployment and drop of production. The decrease of production and grow of unemployment was specially acute in four member countries of euro area :Greece, Portugal, Spain and Ireland.

Therefore the European Monetary Union (EMU) is a subject to a challenge by the present economic crises despite of single market success. It is out of the question that now, that to save the euro in the long run reform of the EMU are required. During the euro crisis there are many propositions concerning EMU institutional reforms. The propositions of reforms are connected directly or indirectly to this the

fundamental question if the euro area should be less integrated or more integrated among members; if partners countries will fight the crisis on their own or in close cooperation with other countries, if the solution for the euro area is to introduce new mechanism of integration to go into proper mix between fiscal and monetary policy or to encourage the most indebted members to exit the euro area ; if the final model of integration to be achieve is a federalist structure of governance in the EU like in some federal states?

The main goal of this article is to analyse the possible scenario of European Monetary Integration ( EMU ) future evolution. The author tries to answer for the questions what necessary reforms should be undertaken to get out from the present EMU' crisis to save the euro as common money and to introduce it in the new EU partner countries. He came to the conclusion that the essential elements of such reform will be the coordination between monetary policy of ECB and fiscal policies in member states.

#### 1. The mechanism of euro area.

The most important of all the potential benefits of monetary integration are price stability, avoidance of transaction costs, low interest rates, increased flows of international trade and capital movement. Theorists of European integration treat the euro and its institutional arrangements as means to restrict the ability of national governments to pursue inflationary monetary policies. The European Central Bank as a fully independent institution makes monetary policy with much less political interference than any national central bank. It is easier for the ECB to fight against inflation collectively than for individual central bank in the national environments. Long distances from national capitals reduce the potential pressure of domestic governments to ease monetary policy based on their political cycles, that always end up with high interest rates.

While the benefits from membership in the euro area may be moderate, cumulative and reasonable uncontroversial in the short run, the costs seems to be much more uncertain in the long run. These costs are not simply of the cost of the administration changeover from currency to another. Rather they are related to the loss of country sovereignty over monetary policy. After accession into the euro area a member country lose the control over its monetary policy and the exchange rate mechanism. Other costs for the an economy are connected with higher openness to trade and international competition, additionally with the reduction of «marge de manevre» and fundamental changes in the formulation of economic policies.

These costs are difficult to quantify, and their true value may appear in the long run, especially in light of the current economic crises underway and necessity to introduce new mechanism against them.

The theory of economic integration assumes that the European Monetary Integration is needed to safeguard the benefits of the internal market. Euro unable partner countries to avoid transaction costs, risk of rate of exchange and large prices discrepancies. All of these served development of trade and factor of production between partner countries and greater economic integration in the single market. The alternative to the EMU might be floating exchange rates with frequent realignments that would lead to competitive devaluations and new trade barriers. Monetary integration has implication for business transaction, as well as for partner countries economic policy. A country that joins the euro area will no longer be able to carry out an independent monetary policy. The growing interdependence of national economies reduces the effectiveness of member states economic policies. Unification of monetary policy implies especially coordination of fiscal policy. Each coordination and unification is connected with new institutional arrangements and economic benefits and some costs

Many economists argue that the EU mechanism is not correctly prepared to fight against crisis. Asymmetric shocks and reallocation of production from one region to the other happens not only in the EU, but also in the federal states like the USA. However, in the EU asymmetric shocks may be more intensive and frequent. The economic diversity between European regions is much higher in the EU and euro area than in the US (1). After a member states relinquishes its autonomy over monetary policy, fiscal adjustment becomes a key stabilizing instrument for partners in a monetary union. In the federal state there exist automatic stabilizers, that transfer income from regions with growing production and tax income to regions with dropping production and income. If one of the states in the US, for example California defaulted the federally insured financial system would continue to pay social security and health benefits. In the US fiscal federalism plays a very important role in offsetting region specific shocks and able to absorb around 40 % of them: a loss of 1 dollar to the income of a US region decreases federal taxes by 34 cents and increase at the same time federal transfer by 6 cent., However, default of one of EU member country would create much more trouble for the entire union, as it lacks the mechanism of federal states. There is no automatic mechanism of transferring Community resources into national budgets. The EU delegates the

task of fighting against economic downturns to national budgets, which may be overburdened by deficits and huge national debt. There is not mechanism of automatic stabilizers similar to that of the federal state. The EU lacks the competency to levy direct taxes and payments unemployment benefits. The relative size of common budget is too small in comparison with the national budget to have any significant macroeconomic role. While the EU budget collect about 1 % of GDP of all members' states, the relation of national budgets towards GDP are more than 40 %. A shock of one euro in regional GDP of a partner country reduces tax payments to EU budget by only half a cent, and transfer to the common budget are able to compensate no more than 1 % of income. The main positions in the EU budget spending: Structural Funds and Common Agricultural Policy cannot act as automatic stabilizers. The aim of Structural Funds aim is to reduce disparities between the levels of development of the various regions and the backwardness of the least favoured regions. The aids are allocated on the basis of long term proqraming periods (now seven years), that are difficult to change. They may only minimally and accidentally alleviate the asymmetric shocks in the members states. The Structural Funds act sometimes procyclically due to the cofinance by national resources. They may also generate, as they have done like in many Polish voievodship deficit in public finances. As Structural Funds do not act as automatic stabilizers, it seems that monetary union should not include too many regions of objective 1 more exposed to economic crises before reaching certain level of competitiveness. In order to carry out the functions of automatic stabilizers the UE budget should have many more resources at its disposition. The hardest hit regions that surpassed the level of 75 % ( like some Greek, Portugal and Spanish regions ) are those where structural aids are limited or have ended. Instead of through EU aids growth in these regions was financed by national and regional budget deficit and accumulation of public debts. In general it seems that federal government has better automatic mechanism to fight against asymmetric shocks then does the EU, where member countries concentrate their domestic insurance mechanism on their national budgets, limited additionally by Maastricht criteria and Pact of Stability and Growth.

The lack of automatic stabilizers in the EU level speaks for the autonomy and elasticity of fiscal policy at the national level. The Report of «One money, One market» underlined that:» the stabilization role of fiscal policy at the national level is bound to remain important in the EMU as long asymmetries persist». Fiscal autonomy is warranted and its role as an adjustment instrument arises

from the need to achieve external equilibrium (2) However, the effects of reaction of fiscal policy and national budgets to cyclical fluctuation may be limited (it depends on its elasticity to changes in output) and relies on solidarity with partners transferring external aids during a deep recession. Studies show that the impact of automatic stabilizers is greater at the national level: the size of the public sector, tax system progressiveness and unemployment benefits, sensitivity of unemployment to cyclical fluctuation, and the share of the tax base to economic cycle are greater at the national level.

Transferring to ECB competences regarding the emission of national currency is connected also with the lost of seigniorage revenue. Seigniorage (also called the inflation tax) is the well known governmental practice connected with the ability to finance its expenditures by printing money. Such a financing of budget deficit through the issuance of low interest debt had been in past main cause of major inflationary crisis. A tax system is rarely neutral with respect to inflation, and higher taxation follows usually higher inflation. According to the theory of optimal public finance, if the marginal cost of rising revenue by increasing taxes exceeds the marginal cost of raising it by seigniorage, the optimal policy is to reduce taxes and to increase inflation (3). Seigniorage was an important source of government revenues for some Mediterranean countries suffering high inflation before joining the euro area ( above 1 % of GDP in Italy and Spain, more than 2 % of GDP in Portugal Greece, which had inflation rate of about 10 % in Portugal and 15 % in Greece .

The loss of the exchange rate mechanism may bring about a balance of payment disequilibrium among partners countries of monetary union. After ten years of functioning of euro area appeared to have two group of member countries : those with trade surplus (Germany, Holland, Austria, Belgium) and those with trade deficit (France, Italy, Spain, Portugal, Greece). In 2011 the balance of payments in relations to GDP was for those countries as follows: Germany + 4.6 %, Netherlands + 6.8 %, Austria + 3.5 %, Belgium +2.0 % and in France — 3.4 %, Italy -2.4 %, Spain -3.8 %, Portugal -8 %. In Ireland balance of payment was negative in 2010 — 1.1 and positive in 2011 + 1.5. The countries with a positive balance of payments represented 39 % of all the euro area population and 44.9 % of the euro area GDP, while the countries with a trade deficit represented 61 % of the euro area population and 55.1 % of the euro area GDP. The different tendency of productivity and wages growth caused some kind of distortion in the competitiveness among member states. In 1999 — 2007 years the wages grew on average 14 % in the

euro area, While in Germany wages grew by only 2 %, they grew by 17 % in France, by 23 % in Italy and by 26 % in Spain The difference in the cost of production contributed to the expansion of German industry on the European Single Market and the growth of its trade surplus, because Germany used strategy of wage restraint to combat the stagnation of the economy. On the other hand, France lost its competitive position in relation with Germany and became more deindustrialized economy, in which only 12 % of GDP was produced in industry sector (4).

Thus far the experiences of euro area show that it is not asymmetrical shocks that matter the most, but rather differences in competitiveness, wages and productivity growth between members countries. Long term growth differences result in external imbalances among members countries and raising the question whether monetary union can withstand national differences in productivity growth. A monetary equilibrium element can be achieved in the euro area in the process of long term convergence. There is proposed new threshold indicator of 3 % as being acceptable to be enforced by a fine to 0.1 of GDP, but it seems that it would be difficult to execute in converging partners with strong investment needs (5 ). The necessary element of this convergence processes is that the real wages in less developed members states increase less than productivity growth could allow. However Greece, Spain and Portugal experienced a substantial acceleration of real wage growth after entering the monetary union.

The ESCB uses the short- term interest rates to conduct monetary policy. In order to finance external and internal deficit the European System of Central Bank (ESCB) has the central position in the member states of euro area. Like other central banks the ECB has monopoly on the supply of cash and control short term rates. It should be noted that in the euro area system, the common currency in circulation is just 9 per cent of broad money (M3). The ESCB finance flows via credits by the euro real — time settlement system countries with external trade deficit receive financing from abroad from the ECB and central banks of partners countries. There are debtor central banks in Ireland, Greece, Portugal and Spain, and creditor's central banks in such countries as Germany, Luxemburg, Netherlands, Finland, and Austria. The central banks of the debtor countries act also as the lender of last resort to country's commercial banks and lends against discounted public debt. Because of the internal payments disequilibrium huge assets and liability have been transferred among the national central banks with the Bundesbank as the dominant creditor. Nevertheless, when the European Central Bank financed

commercial and investment banks in the form of « quantitative easing» with loans at a low 0.5 % interest rate, it could act also in favour to finance potentially solvent partners and keep calm on the financial markets. The ECB implements quantitative easing by purchasing financial assets from banks with newly created money, that increases their excess reserves. These reserves can be used to credit real economy, as well as to buy bonds. Slightly more inflation, and a depreciation of the euro and would be a cost of higher growth and debt reduction and better way to overcome crises then the deflationary policies of highly indebted partners.

However, in this system the ECB is not acting such efficiently like for example the Bank of England -lender of last resort in its own banking systems. There is not guarantee that the ECB's 'quantitative easing and buying debts on the secondary markets would produce even in an indirect way lower debt in highly indebted countries. Consequently the market view of the UK is less sceptical despite a higher debt than in the euro area. The northern partners of the EU are reluctant to use the ECB as the lender of last resort even on the secondary markets and argue for austerity plans in high indebtedness countries. Germany especially worries that if the ECB buys governments bonds that will eventually be the cause inflation. On 21 December 2011 the ECB provided 489 billion low cost three years credits to European banks known as long- term refinancing operation and next in February 2012 additional 500 billion. The total assets of ECB increased to 3.02 trillion euro — about 1/3 of the GDP of euro area members countries. The ECB credits were seen as a kind of backdoor way of supporting government fiscal policy and debt servicing. Some European authorities had hoped, that the banks would use the funds to buy to purchase high — yielding governed bonds, but they are not very willing to invest liquidity in bonds and come back partly to ECB account. (6 ). This backdoor way of financing debtor countries by ESCB cannot of course continue for very long. In the long run the only way for the debtor countries to go out from crisis is to support to equilibrating of the external balance and to return to situation, where the private sectors finances both bank and the governments.

## 2. Reform of the euro area system

The interest payments for some countries constituted such an important part of GDP that it is often very difficult to pay them back. The high interest rates in euro area might come also from the competition between European bonds and American bonds. Chairman

of the Vatican bank IOR shared the opinion that United States was behind the sovereign debt crisis in euro area. If euro area tried to privatized the public debt, the US increased public debt to the markets from 60 % of the GDP to almost 100 % of the GDP, those same markets that before bought public debt from other countries. This led to the replacement of a good part of euro area partners public debt by less riskier American debts. Hence the result are portolios with more American bonds and less European bonds that have to offer higher rates to be sell. In order to resolve the debt problems in the euro area and to save the monetary union from future debts crisis necessary steps must be taken towards not only enforcement of the Maastricht criteria, but also toward creating an effective financial aids mechanism. There are three methods to lower interest rates on bonds issues by some countries in short time: 1. direct bonds purchases through the ECB; 2. a Eurobonds; or. 3 by financial aids.

A country experiencing a budget deficit due to servicing a high interest on bonds would have great leverage on the partner countries and their strong financial integration may speak for bailing out defaulting governments. Hence the present crisis demonstrated to the EU member countries the need to accumulate the common resources for emergency transfers to partner countries with debts and balance of payments problems. As an effect of the financial crisis the European Financial Stability Facility (EFSF) has been set up in the EU to provide temporary financial assistance to member states. The 440 billion euro participation of the euro area members was a part a wider safety program with the IMF that was worth up to 750 billion. The amount sovereign bonds, that need to be issued to service public debt in the euro area is estimated to reach 794 billion euro in 2012 (7 ). The EFSF becomes a kind of regional Monetary Fund; as such it has gained new powers: to make short term loans, to provide funds to recapitalize banks and in exceptional circumstances even buy back the governments debts. (8 ). The access to EFSF aids is tied to strict conditionality of a rigid austerity program and budget control. However taking into consideration the potential for really large- scale lending, the capital accumulated in the EFSF seems to be too small for the tasks. The EFSF must have in the disposition fund that, if necessary lend members states sufficient sum of money to avoid market borrowing at the high rates. The mechanism of financial stability acts to extend loans, for bank recapitalization and for buying bonds in the primary and secondary market. The member states unable to sell bonds at acceptable markets rates may apply for buying them by EFSF. The mechanism of European Financial Stability

Facility seemed to be only little substitute of European Monetary Fund: as a temporary emergency facility it is going to be closed down on June 2013 ( 9 ). From 2013 onwards it will be replaced the European Stability Mechanism (ESM). It seems that in the long term the EU ought to establish some kind of European Monetary Fund, that would be the cornerstone of the measure formulated to deal with budgetary and euro crises in the EU.

The idea of the European Monetary Fund is not new: after the first oil shock a Community introduced borrowing and lending facilities for balance — of — payments support. The first loan for member countries, whose balance of payments had been upset were granted in 1976. The Council increased the volume of borrowing to 16 billion ecu and by 31 December 2000 all borrowing had been repaid ( 10 ). From 1979 to 1991 European Monetary Cooperation Fund ( EMCF ) existed in the framework of European Monetary System to make intervention as necessary to defend currencies in the system. The European Monetary Cooperation Fund accumulated 20 % of reserves of member states to enable countries with weak currencies to borrow in order to avoid devaluation behind fixed brand and long term credits to finance structural reforms. It seems that to be effective the EFSF must follow the example of European Monetary Cooperation Fund and establish for itself a similar function in providing the member countries with short term and long term credit. The European Monetary Cooperation Fund acted in an efficient way to support the ecu and to stabilize the money taking part in the ecu system by market intervention. The mechanism of the European Monetary System comprises three categories of aids: 1 very short term facilities (from one to two months to fight with negative effects of speculative capital flows; 2. short term support (from three to six months) to cope with balance of payments difficulties; 3. medium term loans (from six months to several years) to ease the restructuring of the economy. (11). The proposed types of loans of the EFSF have accumulated less capital than the EMCF and lack of a component, that is devoted to restructuring of the economy. The loans are subject to rather strict conditions and do not acting in such automatic way as in the European Monetary System.

The limited effects of intervention of the EFSF on financial market speak for application the other methods to resolve the euro area crisis: the ECB intervention, banking and fiscal union among partners with issuing the common bonds. The ECB intervention may have lead to stabilization in financial market, but it seems that to stabilize them permanently, the level of intervention ought to be high. It may also

not only lying on the strategy of «quantitative easing» but it also must allow «qualitative easing» to change the assets kept by central banks. Monetary stability in the euro area may be threatened, when if in one or more members states the budgetary situation could lead to default. Default in one member country could have spillover effects and negative impacts on the other member states ability to pay their debts as well threaten the part of banking sector in the euro- area, that keeps the public debts of defaulting country. In connection with difficult situation in banking sector the European Commission proposed banking union among partner countries that would create a common banking supervision and guarantee deposit throughout the euro area. To this goal a common rescue fund is envisaged to directly recapitalise banks. The banking union would force discipline on financial sector by passing rules saying that banks must give reserve for the bonds of states with large deficit. The simple way to resolve the debt problems would be of course possibility to bail out the debtor country debt with ECB money. However, the Maastricht Treaty forbids the ECB from buying bonds on the primary market. If the US Federal Reserve System or Bank of England can function as the lender of last resort, the ECB cannot. Some countries ruled out relying on this intervention on primary markets arguing that it would increase inflation rates and weaken the determination of indebted partners to restrict budget deficit and public debt.

In 2012 President ECB Mario Dragi announced a plan called «Outright Monetary Transaction» that means a quantum shift in the ECB activities against crisis. The ECB wades in alongside the rescue funds purchasing bonds in unlimited quantities of highly indebted countries to bring their interest down. The ECB intervention on the secondary market cut borrowing costs for some EU member countries. In the short run the euro area needs ECB bailout program to protect member countries from contagion and monetary policy to promote growth. An example of positive intervention on the secondary market is the ECB decision in August 2011 to buy Italian and Spanish bonds. Italian debt was huge assessed at 1.8 trillion euro, and ECB 2 billion euro intervention had mainly psychological effect. This intervention decreased the prices of Spanish and Italian 10 year's bonds on the financial market from more than 6.1 % to 5.3 % in Italy and from 6.0 % to 5.2 % in Spain.

### 3. Coordination of fiscal and monetary policy

However, to cure internal disequilibrium in euro area the structural reform in partner countries as well as the institutional reforms in the

EU are needed. The ECB intervention could not individually solve single currency long term ill. The euro crisis that started in 2008 has clearly shown that more attention has to be paid to common governance in EMU, because economic coordination between partners has not been strong enough to prevent macroeconomic and fiscal imbalances within the euro area. Need for a coordination of budgetary policy in EMU arises from growing economic integration and the likely spillover effects, when budgetary policies in one member states may have impact on the economies of other partner countries. Fiscal discipline and more belt — tightening -in the opinion of Wyplosz-increases the likelihood that the EU as a result of the euro crisis could face lost decade in 2010 — 2020 like Japan experienced in the 1990 (12 ). Therefore countries with negative balance and high public debt should adjust as well as countries with external surplus and budgetary equilibrium. In the economic crisis some countries — members of the single market must assume the role of engine of economic growth. The decrease of demand in one group of partners may be recompenated by the public spending in the other countries. The partners that assumes the role of «engine of economic growth « may be the countries in which public finances are in equilibrium or close to quilibrium. More public spending in one or few countries may have positive impact by growth of import from partners carrying out the policy of stabilization their public finances. There would be no inflation pressure, if policy were rightly coordinated among partners and with monetary policy provided by the ECB.

Generally normative theory stresses the «shock absorber «role of budget deficit and prescribes that government debt should be adjusted over time to respond to exogenous shocks. However political scientists outline several reasons why the political system could affect national debt decisions. The weight that the government attaches to the future is affected by two features of the political system: its instability and its polarization. In the less developed countries more unstable and polarized systems behave more myopically. Disagreement among different decisions makers result in the postponement of unpopular policies and accumulation of public debt. The less likely a government is to be reappointed, the higher amount borrowed is. A weak government unable to cut expenditures or raise taxes treats public debt as a residual source of finance. Hence debt reduction is not only a economic decision, but intrinsically related to the working of the political system.

On the one hand governments finance budget deficits by increasing public debt, on the other hand they collect taxes to pay interest to

bondholders. When governments collect taxes to pay interest payments, an excess burden is created. The need to make the interest payment on a large debt may also contribute to growth of inflation. Since the EMU removes the possibility of adjusting the individual interest rates in any country, the rise in interest rates can no longer be limited to the country running a budget deficit. If governments sell new bonds to pay off the holders of the old bonds the question arises whether it is possible for governments fail to make payments back and like a business corporation to go bankrupt. It is frequently stated that a government cannot go bankrupt because it has the competency to levy taxes in whatever amounts are necessary to service the debt. Furthermore, governments have also the power to print money at least indirectly pressing central bank to create additional money to avoid default. Growing inflation may decrease the value of circulating public debts. However in the euro system the governments of member states have lost their any influences on the ECB decision to supply money. The central banks cannot also decrease the value of debts by growth of domestic inflation, as that is limited by the ECB goal of price stability and taken into consideration throughout the euro area. Partner countries have become aware that the bail-out option of exchange rate devaluation no longer exists. The extent means with which reduce debt rest entirely on budget policy. Hence it seems that for these reasons the probability of default for a highly indebted country is higher among member states that are outside the euro area.

The theory of fiscal federalism points out, that fiscal responsibility can be divided between the UE and the members states in the same way as they are divided between national's states and its regions. There are two main economic arguments speaking for fiscal federalism: 1. spillover effects (negative externalities) if actions undertake in one country lead to inefficient outcomes in the partner country; 2. increasing returns to scale when for example an anti cyclical policy is more efficient when carried out on large scale. The common exchange rate policy must be a part of this mix as well as the surveillance of macroeconomic imbalances, and including competitiveness divergences. There are also two main arguments for retaining fiscal sovereignty with monetary union' partner countries: heterogeneity of preferences and information asymmetries. These arguments indicate that national or regional governments are the best suited to shape fiscal policy to regional preferences (13). ). Thus far the EU initiative to improve economic governance seems to be moderate and perhaps too late steps towards effective coordination. The EU propositions take into account the second group of arguments

to avoid and correct budgets deficit and public debts in fiscal policies in member states. Governments also put stress on political controls of EU institutions over deficit and debt development to be more strict and automatic . The fear of the loss of sovereignty with regard to this state of affairs comes from mingling two crucial aspects of fiscal policy: structural and stabilization. Structural tax policy is mainly microeconomic and can be decided upon at the national level. However the income stabilization policy can be accomplished effectively at the supranational level.

Overall, in the euro area macroeconomic stability is provided by national budgetary policies, that perform a function as shock absorbers in any single country. There are valid arguments for jointly imposing discipline and budgetary stabilization coordination as well as optimal budgetary spending in all area in the time of crisis. In 2010- 2013 most EU members faced the problems of excessive public debts and had to increased taxes to speed up fiscal consolidation. Tax consolidation is an important means to recover budgetary and external trade equilibrium among partners in the euro area. However, in the fully liberalized European capital market, the excessive growth of taxes in one country may have negative externalities due to costs of capital outflow. Lost of a tax base in one country, that reduces the supply of that country's public goods may be correlated to an increase of the tax base in partners countries. Simulation conducted by the Institute for Prospective Technological Studies shows, that the loss of efficiency due to tax increase would be reduced if the tax rises in the EU countries were to be coordinated in order to « internalize trade — related spillover effects». So fiscal consolidation in the EU should be arranged in coordinated manner as well as should be increases of taxes and the types of taxes included ( better indirect taxes than direct taxes ). The result of the analysis indicated that efficiency gains would be potentially higher for VAT than labor taxes ( 14).

In the euro area no bail out clause implicitly assumes that a member country could become insolvent. In the US the default of a state is possible whenever lower level governments are in financial trouble. Nevertheless the US federal system can print dollar to cover debt but in euro area the ECB cannot. Several European governments have put pressure on the ECB to greatly increase its purchases of sovereign bonds, that they regard as a possible solution to the debt crisis. It seems that in time of crisis the ECB may assume a more active role to contain the euro area debt crisis, and under the conditions to undertake the necessary reforms in highly indebted countries. A loosening of ECB policy is connected also with a

weakening of the euro as it dropped to low level of about 1.2 doll per euro at the beginning of 2012. An economic rule of thumb explained that a 10 % fall in the euro may boost export and economic growth of about 1 % after six months, especially in export countries that are the most sensitive to euro exchange rate. Moreover, all member countries may accept a modestly higher overall inflation than the Maastricht price stability goal allows rather than falling into a possible deflationary spiral. Temporary money creation would not be inflationary in a depressed economy and it would help to avoid high employment and reduce public debt in some euro area countries. It seems that the task of the ECB should be enlarged beyond only the keeping an inflation down. The ECB should be also responsible for financial stability and growth: if financial stability is paralyzed then the growth will not come, so a better way to growth is through «quantitative easing» that will recover financial stability. After ten years of restrictive monetary policy it seems that temporary ECB intervention would not destroy its reputation.

However the ECB cannot substitute for fiscal policy coordination in euro area. Against the ECB indirect «hidden» fiscal transfer there are propositions concerning the introduction of a eurobond to be issued by a single euro area authority ( EBC or by European Investment Bank ). Eurobonds placed on the market by the EU institutions are to convert a share of national members countries debt to the Community. The eurobonds may be also guaranteed by intergovernmental agreement, as such they would gain more trust that bonds issued by the governments of the member states. The bonds could be buying by foreign investors and many of them are in favor to invest in eurobonds against national bonds. Jean -Cluade Juncker — president of the Euro group and Giulio Tremonti- Italian ministry of finance — proposed to issue euro bonds represented up certain limit : to 40 % of the GDP of the EU for maintaining not only the budgetary solidarity of members states, and also serving of default and bailing out of the bonds of the member states (15 ). There are also propositions to establish a system of common issuance of bonds in a progressive and partial way up to a maximum of 60 % of GDP. A conversion of debt up to 60 % of the GDP from members countries to the EU would mean that their remaining debt would be Maastricht compliant. The creation of eurobonds may bring the lower interest rates and attract foreign capital to invest in their emission, for example from China. It may mutualise debt in the euro area and reduce the borrowing costs of such countries like Spain or Italy. However issuing jointly backed euroobligations would not make sense until the euro area reaches some kind of fiscal

union. The eurobonds will function correctly only, if they possess sufficient sovereign economic policy power to ensure their credibility. The benefits of a euroobligation relative to no bail out actions is generally considered to be greater financial stability. The German opposed eurobonds initiative, because of fears that weaker countries could get free-ride on the stronger credit ratings of stronger partners. Eurobonds may have higher rates than German bonds but less than in the other countries. Germany is afraid of a growth of interest rates and raise expectations among market participants that eurobonds would become the norm and a factor that could actually promote future crises. Overall opponents of eurobonds underline the possibility of mutualisation of some losses, excessive emissions and higher inflation in the single market. Nevertheless euro area countries have not yet set out a road map towards eurobonds and the partner countries are rather in favor of setting up euro area common bail-out funds, that would be able to buy sovereign bonds.

Moreover, euro area needs a banking union with common banking supervision. European banking union is proposed with common capital requirements and supervision and deposit guarantee system (DGS) with a goal to compensate bank deposit holders for failures of individual bank. Integrated supervision of banks in the euro area is necessary to ensure the application of common prudential rules. Such supervision may reduce the probability of bank failure and prevent the spreading of crisis throughout the whole EU. The banking union should also minimize the cost of eventual bank failures and financial intervention to citizens of member states. The current architecture of European regulations provided incentives to buy governments debt consider as «free of risk». For example, European banks were not obliged to set aside additional reserves, when they bought governments debt. Hence new rules have been proposed (Basel III banking rules) that would be introduced in 2018 to hold capital reserves to at least 3 % of all their holding. Parallel to this process is the creation of a common fund to bail out failing banks and guarantee deposit over the euro area. The credibility of any deposit guarantee requires of course access to a solid financial backstop. A European deposit insurance scheme could introduce the international dimension to national deposit guarantee schemes for banks overseen by the European supervision. So called banking union is a part of proposed new economic governance of the euro area able to carry out a proper financial policy for all member states.

Van Rompuy report in June 2012 mentioned four essential building blocks of a genuine economic and monetary union that will

have to be put in place over the next. In the view of report they offer a coherent architecture for long- term stability and prosperity of EMU and include:

1. An integrated financial mechanism with a view to ensure financial stability, common supervision of banking at the European level, resolve banks failures and guarantee customer deposit,;

2. An integrated budgetary framework to ensure sound fiscal policy making in euro area. Such framework encompassing coordination, joint decision- making, different forms of fiscal solidarity, commensurate steps towards common debt issuance;

3. An integrated economic policy coordination at national and European level to promote sustainable economic growth;

4. Democratic legitimacy and accountability of decision- making within the EMU (16).

The common monetary policy must be joined more closely with harmonized tax policies in the member states. Public spending coordination cannot be concentrated only on the one country market and political cycle, but must take into the consideration the spillover effect on the partner countries. The Maastricht criteria should govern without exception among the states and public finances should be considered jointly when the deficit in one country may be «equilibrated» by the surplus in partner country. Fiscal policy coordination is needed to discourage free riding and to induce governments to internalize the negative externalities. Uncoordinated fiscal policies might drive up interest rates EU over the entire EU, depressing capital formation, growing national debt and hampering Europe's international competitiveness (17). In the future it is only under conditions of strict common fiscal policy that it would be possible to enable the common borrowing for eurobonds. Common emission of eurobonds in the framework of the EU budget equipped with more resources and more harmonized taxes might avoid the problems of financing of public debt and spreading in interest among members states. Like in the European Monetary System one can also envisage setting up a European Monetary Fund that is able to bail out national's debts and transfer stabilization aids from richer European countries to the euro-zone periphery.

4. The evolution of euro area before accession of transformation countries.

The worst outcome for the highly indebted euro area member countries would be to leave the euro area to accomplish devaluation of their national currencies. The decision to leave by one, few many or

even all the countries of the euro area should be based on the profits and costs analysis regarding the economic effects imposed on his economy and the whole European Single Market. A country can withdraw from the EMU in order to be free to resort to debt monetization. To the extent that debt would be denominated at home currency (instead of euro), this could alleviate a country's public finances. However, coming back to the home currency may be connected not only with administrative costs of money exchange, but also higher inflation, collapse of financial sector, a loss of credibility, and corporate defaults and separation for years from capital market. Negative effects would be felt as well in the euro area in the form of higher inflation, and a drop of trade and investment. Sometimes the example of Argentina has been evoked, which Argentina fell into financial crisis in 1990 having fixed exchange rate of its peso to the value of the US dollar. Argentina entered a spiral of external trade and budget deficit until it devaluated the peso and restructured its public debt. After devaluation and debt relief Argentina returned to the path of economic growth. However a return to a free exchange rate by the members of the euro area would be costly to the all single market. At sum all the partners may lose: a devaluation of currencies of the weaker members might accompany an appreciation of the currencies of stronger partners (Germany, Austria, and Holland, Finland). After that the regional policy may be reforming and diminished as well as the common agricultural policy. Protection tendencies could arise and the Schengen agreement could be dissolved. So a country that is considering exiting the euro area should taking into consideration that there may be little prospect that devaluation offers much and that structural reforms may count for much more.

One can hardly imagine that the members of the current euro area would accept as a solution such a leap backwards into completely freely exchange rates. The cost of reintroducing a national currency seems to be much greater than leaving only a fixed exchange rate like Argentina did. The introductory calculation estimated a decrease of at least 10 % of GDP of the euro area in the case of dissolvent. Daniel Gross shared the opinion, that while Greece might ultimately require financial aids of about 400 billion euro, allowing Greece to abandon euro would cut its nominal GDP by at least half, making debt equivalent to 400 % of GDP ( 17 ). A breaks up of the euro area may turn out to be too costly in comparison with deeper integration and fiscal union. The cost of breaking up with the euro may be especially important for the small open economy, because for these members internal reforms are better alternative. According to the UBS assessment each Germany citizens

will have to pay at least 1000 Euro to bail out Greece, Ireland and Portugal's debts,; hence the cost of an eventual bail out seems to be lower, than the cost of an eventual break up of the euro area (18). For example, Slovakia's export oriented economy has recovered quickly from the financial crisis. After two years of budget deficit at nearly 8 % of GDP, the government cut spending and raised taxes to the level of 2.5 % of GDP. Belgium is another example of a country that has successfully reduced its public debt. Once the most indebted country in the EU ( with a ratio of debt at 134 % to GDP in 1993 ) Belgium steadily reduced its debt to 84 % by 2007. Thus default is then unnecessary, if sensible reforms are introduced.

The present crisis of the euro area shows, that euro as a currency seems to be more an element of the economic union than an element of the European Single Market. The single market may function with euro and without the euro and the benefits deriving from the one money for one the market are rather modest. In practice the size of the cost of exchange rate instability suggest, that it is restrained obstacle to trade development. By and large traders seem to be able to hedge against the risks of exchange fluctuation. National currencies are in the same way restrictive to foreign direct investments. However when foreign investments are treated as alternatives to exports, some investments may be encourages by the existence of currency risks. According to the theory of optimal currency area the economic benefits from one money for the single market are conditioned on several assumptions. In asymmetric shocks members countries have at their disposition two safety valves: elastic labor marker or fiscal policy. Because the labor market in the EU is two times less elastic than that in the US, in the euro area the burden of fighting against crisis fall to the fiscal policies in the member states. Common fiscal policy in the euro area may take the form of supranational fiscal policies with a centralized budget or some part of it or through coordination of fiscal policies in member states. A centralized budget would be able to accomplish fiscal transfers from more to less prosperous region and — in the opinion of P.Mortimer- Lee — without them the prospects for EMU are rather gloomy ( 19 ). Coordination adaption of common regulations, and harmonization of national laws and rules, it may also lead to convergence of the target variables of policy (20) The frontier of the EMU should be limited by the possibility of conducting the effective coordination of fiscal and monetary policy between member's countries.

Therefore political factors of monetary union seem to be at as important as economic factors. Some authors asserted even that the

raison d'être of monetary union was political rather than economics and the success of monetary integration rests on political union, and not on economic theories. (21). The euro was introduced not only to enlarge economic profits from the single market, and also to speed up European integration towards economic union. Before the establishment of the euro area H. Tietmeyer president of the Bundesbank argued that after certain point economic integration cannot realistically be expected to advance without the prospects of progress in the field of politics (22). The transfer of an elementary sovereign right such a monetary policy to the ECB is likely mark that point. O. Issing shared the view that if it is to be workable at all monetary union requires full political union (23). M. Wolf predicted in 1996 that under the EMU there would be incentives for individual governments to pursue deficit financing with the expectation that they would be bailed out by the ECB. The greatest risk is that those countries with initially high levels of public indebtedness might find the effort of lowering public debt excessively painful. This risk would be reflected in high euro interest rate (24). The latest financial crises have also convinced European politicians to attempt closer political union. During a meeting in Strasbourg in 2011 even German chancellor A. Merkel fixed on the long term goal of fiscal union. Merkel underlined that changes to the European Treaties are the only way to restore confidence in the financial markets. (25). Some politicians are aware that monetary union requires the relinquishment much of the budgetary sovereignty held by member states.

Although the stable currency and low interest rates have been helpful to the European Single Market, more needs to be done to ensure better governance in the euro area to improve budgetary coordination or even partial budgetary unification. The common monetary policy seems to be more an element of economic union than a single market and that the latest crises have showed that in the future transfers of national policy sovereignty from the member states to supranational organs is necessary so that the monetary as in fiscal policies may be better coordinated, as they must be properly functioning of a currency union. A key reason why a single currency works in the US and does not work so efficiently in the EU is the insulation provided by the federal fiscal system. Managing a large monetary union should be straightforward like in the Federal State. Monetary policy requires the Central Bank to take monetary decisions in the name of all members countries as well as manage the substantial union wide budget to transfer income from more successful parts to the less successful countries and regions.

Government borrowing should operate through a single union wide bond market with borrowing determined by a decisive central authority. In the US Federal Reserve manages of the union's monetary policy via a single bond market with borrowing belonging to the institutions of the federal states, while the borrowing of states and municipalities is constrained due to their inability to monetize their debt. After war of independence the USA confronted the same problems with the debts incurred by the the states as euro area did and had resolved it by assuming these debts issuing new federal debts. Because of the need to bailout of debt in some countries, central control over budget deficit seems to be necessary. The EU moved towards the EMU without giving it the ability to bail out public debts of partner countries and make transfers between them because of the limited size of its budget. Therefore, in the period of economic crisis a new fiscal pact for economic convergence in the EU is need and it must complement the current plans of austerity measures. Cohesion policy and structural funds that concentrate their activities on income convergence between partners and their regions, should reoriented their policy also to include the stabilization goals. The European Investment Bank may deploy funds to match investments in countries undergoing structural reforms. Furthermore the ECB should be more proactive in buying the public debts of partner countries. The ECB can assist the banking sector in reforming countries and operates on the market to bail out countries debt. In the view of such grow of debt and the rise of interest rates in some euro area countries, the question arises whether part of the countries will be able to pay back their debts and manage to deliver on both fiscal disciplines and economic recovery. To put it another way will Germany and other northern members of the UE southern countries by bail out and reschedule their debts and by offering them palliatives such as reduced interest rates for emergency loans. The financial crises in 2008 -2013 showed that the euro area institutional system is inherently fragile. Due to the economic and financial interlink among the member countries the fragility of one or a few is becoming fragility of all the partners.

The financial crises have exposed the weakness of the Maastricht Treaty and further integration seems to be the solution to the current crisis in the euro area. The crises revealed that monetary integration has crossed the Rubicon towards more harmonized economic policy. Monetary integration simply does not work without further tax integration policies among member states. Countries of the euro area fell into debt crises relatively easily despite Maastricht conversions criteria and Stability Pact. To make the convergence criteria more

obligatory partner countries have agreed to introduce more strict debt and deficit rules to be included in the law of member states, but there is no guarantee that debt crises will not happen again. To escape from the current crisis and prevent the future one, there is no alternative, but to elaborate a proper policy mix between monetary policy and fiscal policy. Now in the euro area there is a combination of decentralized national fiscal policy with rather strict monetary policy. Budgetary policy in the euro area works primarily as an absorption function at the national level, and less at establishing of an optimal budgetary spending for entire EMU. The reforms before further EMU' enlargement should institute more strict and coordinated fiscal policy and more proper monetary policy taking into consideration financial stability and economic growth. It is not a question of introducing one or other new instruments, because one instrument can be substituted by another. Rather this is a new viable institutional arrangement empowered to carry out rational economic policy. Monetary union should lead to fiscal union and fiscal union to banking union with deposit insurance in the EU. A banking union in euro area would probably be unworkable unless accompanied by a full fiscal union. Some economists think that the euro can be saved only by stronger economic union among member states. The European Commission even indicates necessity to establish of some kind of common economic government able to take up economic decisions and formulate common economic policy. The EU must put in place some form of economic government, that is able to coordinate fiscal policies with monetary policy of the ECB. The best chances for economic recovery involves governments working together to increase demand and to augment business confidence. No institutional reforms in the euro area means acceptance of internal fragility and rise a danger of stopping further enlargement. Of course government debt and the potential for default cannot be linked only to the euro and functions of the ECB. In a federal state like the US nobody linked the potential default of one state to the dollar functioning as a legal tender. For example during a recent budgetary crisis the State of Illinois simply stopped paying 5 billion of its bills, California issued vouchers for wage payments. In both states there were cuts in public services. However, nobody envisaged a bail out financed solely by the other US states nor an exit from monetary union. An analysis of the institutional manner in which the US deals with the crisis reveals federal country wide prudential rules for banks and Federal Reserve System as a lender of last resort (26). The central budget in the USA also helps states by automatic stabilizers when economic crisis begin.

Moreover, in the US there is a dialogue between the Federal Reserve and President of the US, such a dialogue does not exist in the euro area neither between the ECB and the European Commission nor between the ECB and governments of members states (27).

Thus far we do not know precisely what the economic benefits and costs of closer economic union and coordinated economic policies are. Coordination commits partners to agreement on the actions needed to accomplish a coherent policy for the euro area. The basis for the coordination coming from the fact that in euro area under the Maastricht Treaty ( given the openness of the European economies ), no member country alone has an incentive to expand demand issuing fiscal policy. Because a large part of the benefits of increased growth and employment would accrue to its neighbours and most cost of a deterioration of balance of payment would fall on the country itself, a country withstand to assume a role of locomotive of economic growth. So if every country decides on its fiscal policy independently, taking into account only its own interest, euro area fiscal policy would be on average deflationary. A coordinated expansion by all member countries of euro area would therefore have a much bigger positive impact on growth and employment.

Because banking sector bears the huge costs of the euro crisis first of all there is also a need of coordination program in banking to recapitalize some banks in different partners to make them solvent. European banking union is proposed with common common capital requirements and supervision and deposit guarantee system ( DGS ) with a goal to compensate bank deposit holders for failures of individual bank. Governments could also do much to coordinate economic policies so as to better align spending and taxing .These coordination can help to avoid of contradictory means and negative externalities, and to provide proper income stabilization policy for all euro area. In order to coordinate effectively the fiscal policies among members states the credible text plans for budgetary projects should be drawn and based on independent growth forecasts and checked by» independent budgetary council». To this goal it is necessary to normalize and harmonise presentation methods concerning national budget, that partners budget can be aggregated to establish a consolidated euro area budget( local and social finances included ). The coordination should be served by Eurostat as an independent European statistics agency combined network of National Statistics Agencies(28), does not necessarily mean total unification of all national budgets into one supranational budget. It may be linked with some further harmonization of taxes, like direct taxes for enterprises at a minimum

level of 18- 20 % . Accumulation of more common financial resources may be linked to EU budget or more resources may be transferred to the European Financial Stability Facility ( later to European Stability Mechanism ). Without at least partly mutualisation of partner debt and a larger bail- out funds ( for example in the form European Redemption Fund ) fundamentally solvent countries might be forced into financial crisis on an occasion of economic downturn. According to Ch. Saint-Etienne the enlarged EU budget able assume new functions might be composed from one third of taxes levied on firms, 0.5 % from the value added tax, 1 % on all revenue and 2 % on all consumption spending in the euro area. The enlarged EU budget or stability mechanism would then be able to absorb effectively asymmetric shocks in the euro area before they affected all partner countries. It can help with adjustment problems in the monetary union, if the common budget is equipped with common resources so that should a arise occasion and funds must be transferred, the transfer can be organized. Moreover, coordinated fiscal policy might include not only some fiscal standards, and also common rules concerning spending on the occasion of an economic downturn. Coordinated budgetary spending should serve first and foremost the strategic growth policy of the members states and support mainly: research and development, creation of the new technology and products, energy policy, and development of infrastructure, finance a European Venture Capital Fund for small and medium firms etc. (29). In order to finance such growth under the European economic recovery programme and to stabilize euro area debt the EU may issue also its own bonds up to 60 % of partner's GDP rather than only national bonds denominated in euro. Euro bonds proposition seems to be complementary initiative to policy coordination, as they can bring the best effects in the framework of fiscal union. President of ECB Dragi told that Euro bonds make sens when we have a fiscal union, otherwise they don't make sens. European Council President Herman Van Rompuy stated also that Eurobond could be considered only after a new stage in the EU's fiscal and economic integration. (30).

As the debt crisis in the euro area is getting worse initial condition to combat the crisis is reducing the public debt. It is rather unrealistic in the short term to reduce significantly government debt in the euro area through the budgetary surplus in member countries. It is possible to attain this goal by classic methods: a).debt restructuring) debt forgiveness or c). Debt monetarisation. Debt restructuring is to be deep enough to bring the debt to 60 % of GDP of member states. This scale reduction will inevitably lead to a banking crisis that would require government intervention and more public debt. Many

government resources will be needed to recapitalize the bank after the debt restructuring. The main potential pool of money the European Stability Mechanism that should eventually reach the firepower of the 500 billion euro. If one compare capital of the European Stabilisation Mechanism with the total debt crisis countries- Greece, Ireland, Portugal, Italy and Spain, which account for about 3.75 trillion euro, it is obvious that the resources of the European Stability Mechanism is nowhere near big enough to cope with a series of debt consolidation: b) in the case of debt forgiveness the mechanism of the Paris Club could be created to forgive part of the debts of euro area member countries. If we assume that all other euro area countries to forgive quarter debts of Greece, Ireland, Portugal Italy, Spain and France, this will be write of debt forgiven countries, that is about 1.2 trillion euro — about 30 % of GDP . On the other hand if Germany covers these losses, the national debt would reach about 110 % of its GDP. The money used for debt forgiveness seems to be so huge that the Paris club' solution seems possible only for a small member country of euro area like Greece.

**3 Debt monetization** The central bank acts often as a lender of last resort. De Grauwe made an observation that the cause of the debt crisis in the euro area would be limited if the markets do not believe that the ECB was ready to move public debt (31). Monetization of debt has a bad reputation because often lead to galloping inflation. This inflationary policy mans that all member states of euro area (Germany included) will share losses inherent in the debt restructuring. So it seems that debt monetarisation policy is not possible to be executed in euro area because EBC cannot buy bonds on the primary market (only on the secondary market), when the debts matures, the countries would have to pay interest and principles to ECB, that means there will be transfer in the wrong direction from the country being helped to help countries.

To combat excessive public debt it is also possible to sale of states assets. It seems possible for governments with a large national debt to sell some of its assets and use the proceeds to buy back their bonds. This operation will reduce payments of interest of debts and their exposure to volatile market. Sale of assets can bring a lot of really gross debt decreased by a significant amount. For the euro area as a whole the states assets amount to about 3 % of GDP. OECD estimates serious value of net debt that can be used to recover the valuation of assets (calculated as gross less net public debt). For Greece the reduction of debts due to selling public assists might reach the level of 61.9 %, for Portugal 45.1 %, foOr Ireland 44 %, for Slovenia 52.8 % ( see table no.

*Table 1***ASSESSMENTS OF DEBT REDUCTION DUE TO SELLING  
OF STATE ASSETS IN EURO AREA MEMBER STATES.**

Austria — 34.6
Belgium — 21.7
Germany — 37.6
Greece — 61.9
Ireland — 44
Finland — 117
France — 39.6
Italy — 27.3
Netherlands — 38.9
Portugal — 45.1
Slovakia — 31.7
Slovenia — 52.8
Spain — 29.3
Source: Economic Outlook, OECD, June 2013

In the short run the euro area needs more investments, slower fiscal adjustment, looser monetary policy to promote growth and a more financial support to protect member countries from contagion. In the long run the euro area needs structural and institutional reforms. For the future development of Europe Agenda 2012 calls for greater cooperation between EU partners regarding the quality of public spending and to get this positive synergies the euro area finance ministers will have to turn budgets around to stimulate spending and potential growth. All proposed steps against euro crisis are mutually collared: monetary integration requires stricter fiscal integration, fiscal integration requires banking union but banking union is going to require some form of a political union. This way the debt crisis in the euro area may present an opportunity to renew the strength of European institutions. It was often repeated during previous crises in the EU that integration process in Europe cannot be stopped. It is like a snowball at the top of a large hill or like riding the bicycle, that we must always pedal, new crises leading to new solutions and more intensive integration among member states. It seems that it is in the

vital interest of Poland and the other transformation countries is to join only a strong euro area with good governance and a fully fledged mechanism managing it, that is able to effectively carry out monetary as well as fiscal policy and more automatically overcome unequilibrium and eventual financial and economic shocks. Otherwise, the attractiveness of monetary union beyond the European Single Market (which brought for example Poland the most integration profits) seems to be limited.

In the long run Poland and other transformation economies have the opportunity to reach the other benefits from membership in the integration processes. As for transformation economies joining the euro- area the decision to do should be based not only on the actual economic profits and costs of monetary union, but also on the ability and willingness of the euro area to accomplish necessary reforms. Now central European countries may expect rather moderate economic profits to come from euro. The benefits for Poland and other transformation economies from eventual accession into euro area seem to be less than those from single market and structural policies. New EU member countries gets most of its integration profits from free trade and investment flows, Structural Funds and direct aids to agriculture. The euro currency can bring transformation economies all the benefits of a single market, but only under the conditions that can be created by a full-fledged economic union. The standard analysis shows that benefits for transformation economies would be comparable to those realized upon the elimination of non-tariffs barriers under the single market program and would give an additional moderate impulse up to 0.5 % — 1 % to economic growth. This additional growth would come mainly from: intensification of trade with the EU partners, increase in competition, elimination of risk in rate of exchange and transaction costs, increase in the attractiveness of the market for international investments, new possibilities for economic institutions to finance their activities. Although short term benefits from accession to the euro area may prevail over economic costs it should be stressed that in the long run higher profits depend upon further reforms inside the EU and in transformation economies. Without institutional reforms, dynamic growth in investment and productivity, and a more elastic labour market, the EMU will lose competitive position in the long run. The importance of costs bearing from eventual functioning of common currency in transformation economies would be also related with further structural changes in the economy, growth of productivity and reforms of the labour market. The economic costs may occur in the long run that is related with the

fact that economic structure of many the central European economies economy are not perfectly similar to the EU core countries and low flexibility of wages.

The crisis in euro area is writing a new chapter in the history of the European integration: stop monetary integration in the present form or to proceeds to reform EMU. To save the euro more efforts has to be paid to common governance in EMU, because common institutions have not been strong enough to prevent macroeconomic and fiscal imbalances within the euro area. It is obvious that the federal government is better equipped with automatic mechanisms to fight against asymmetric shocks then euro area. In the EU there are neither tax that are paid directly to the common budget nor unemployment fees that are transferred from common budget to depressed regions. The lack of automatic stabilizers mechanisms similar to those of the federal state unable partner countries handling crisis aids automatically. The question is how to govern the euro area in crisis without commitment to political union, when the situation requires the use state like tools to respond. Further integration of financial resources and common economic decisions seems to be possible solution for the euro area. Functioning institutional structure of the EU has created inconsistency between monetary and fiscal policies and suboptimal economic outcomes. These two most important economic policies should act in harmony to save the partners countries equilibrium and to promote economic growth. A completely centralized monetary policy puts more weight on fiscal policy in member states to counteract economic disturbances. However, national fiscal policies did not fully perform the functions neither shock absorber nor optimal budgetary spending. The Maastricht Treaty has not provided the necessary institutional structure for the accumulation of common resources with a view to redistribution goal and proper coordination a common monetary policy with completely disintegrated fiscal policies. Fiscal policies within the euro area have tried to replace the stabilizing role of monetary policy, but they have turned out to be imperfect substitutes, when it comes to resolving macroeconomic imbalances. Budgetary policies in the euro area aim primarily at absorption function at the national level, but less optimal budgetary spending for all EMU. Reinforced fiscal coordination and ex ante confirmation of national budget deficit would make more effective fiscal and monetary policy possible. More fiscal coordination should be connected with more fiscal discipline between partners. It seems that the euro area must become a more tight fiscal union with more transfer payments used temporarily to build up

automatic stabilizers to get out quickly from economic crises before further enlargement towards new member countries. The need for larger, perhaps separate budget for euro area arises also from the loss of the exchange rate instruments in member countries. Need for a coordination of budgetary policy in EMU arises from growing economic integration and the likely spillover effects, when budgetary policies in one member states may have impact on the economies of other partner countries.

The EU' progress towards a more integrated structure is probably the best answer to the debt crisis in the partner countries. Further integration of economic policies with a view to promote growth seems to be the best solution to overcome the debt crisis. The euro project deserves more institutional design and better economic governance because the single money cannot exist anymore without good governance and proper mix of monetary policy and fiscal policy at the European level. The important issue is not only fiscal policy, but also more active role of ECB: one or several new instruments would serve the ECB' goals to be reoriented more to stabilize economies of member states, and not only keeping inflation down. The ECB must assume the role of lender of last resort towards the high indebted countries at least at the secondary market. The ECB cannot of course substitute for fiscal integration and be a subject of moral hazard. Both policies must be properly coordinated to stimulate growth and avoid unbalances. To overcome the debt crises Europe needs a truly comprehensive package; banking union with common deposit guarantee system, fiscal union with budget enable the transfer of savings between members with surpluses to members in deficit and furthermore changing the priorities of ECB also seems also necessary to handle the crisis. The obvious solution to euro area crisis is to have a banking union, a fiscal union and a political union together. All proposed steps against crisis in euro area collateral and one steps followed the other: monetary integration requires sticker fiscal integration, fiscal integration requires banking union but fiscal and banking union are going to require some form of a political union. Because banking sector bears the huge costs of the crisis in euro area there is a need of centralised resolution and supervision mechanism as well as of new funds to deal with liquidity problems to recapitalise some banks in different partners. In the long run a country and its banking sector cannot recover without macroeconomic stability and economic growth. It is not a question of a single instrument that can be substituted for another. The euro can disseminate all the benefits from single

market for transformation economies only under conditions of the full economic union. One economic policy, one money explains more than one money, one market.

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## **THE IMPROVEMENT AND DEVELOPMENT OF SHANGHAI'S URBAN ECONOMIC COMPETITIVENESS**

**Abstract** As one of the greatest metropolises in China, Shanghai has been playing a critical role in China's economic development. With the launching of its construction of «Big Four Centers», namely the Shanghai International Economic Center, the International Financial Center, the International Trade Center and the International Shipping Center, Shanghai is now having its industrial structures being adjusted and bettering the proportion between its secondary and tertiary industries. Meanwhile, Shanghai is also making full use of the «post-Expo» economic effect, focusing on constructing the Free Trade Zone, attracting high quality foreign investment, building its brand new international image, and enhancing its urban economic competitiveness.

**Key Words** Economic Competitiveness, Industrial structure, The city's comprehensive service, Free trade zone.