1.

Macroeconomic developments and policy responses in diverging Europe

Introduction

The global financial and economic crisis that was so dramatically unleashed in 2007 propelled into the limelight the divergence in macroeconomic developments among the eurozone member states that had been taking place as a result of the gradual build-up of macroeconomic imbalances between 1999 and 2008. The failure to take appropriate and timely steps to reverse these imbalances was also a root cause of the new series of difficulties that broke out in the eurozone as from 2010 in the form of a sovereign debt and banking crisis. These developments did not fail to affect also non-eurozone countries. Several of them faced balance-of-payments problems in 2007-2008 and few managed to avoid the slowdown – if not slump – of their output growth.

The EU/eurozone response involved the provision of financial support to member states facing sovereign debt and/or balance-of-payments crises, in exchange for strict conditionality programmes as well as a series of economic governance reforms, the purpose of which has been to prevent the re-occurrence of similar crises in the future. At the heart of this approach has been an emphasis on fiscal austerity and, where necessary, the correction of any external deficits.

The debate on whether this approach has been optimal is on-going (see also Chapter 2), especially as, in most cases, the recovery that was expected to follow the fiscal stimulus in 2009 was stopped dead in its tracks. Instead of showing signs of recovery, those member states that found themselves initially most affected by the crisis have now plunged into major recessions – unprecedented in the post-war era – which, on account of the close integration of the national economies within the EU, have begun to take their toll on the EU economy as a whole; at the same time, the crisis has been spreading instead of being contained across members states and their banking systems.

This chapter takes a look at the macroeconomic developments and policies of 2012 in an attempt to spot any divergent trends in important real macroeconomic variables. It also asks whether the policy responses to the crisis have proved effective in containing divergent developments or whether they contributed to fuelling them still further.

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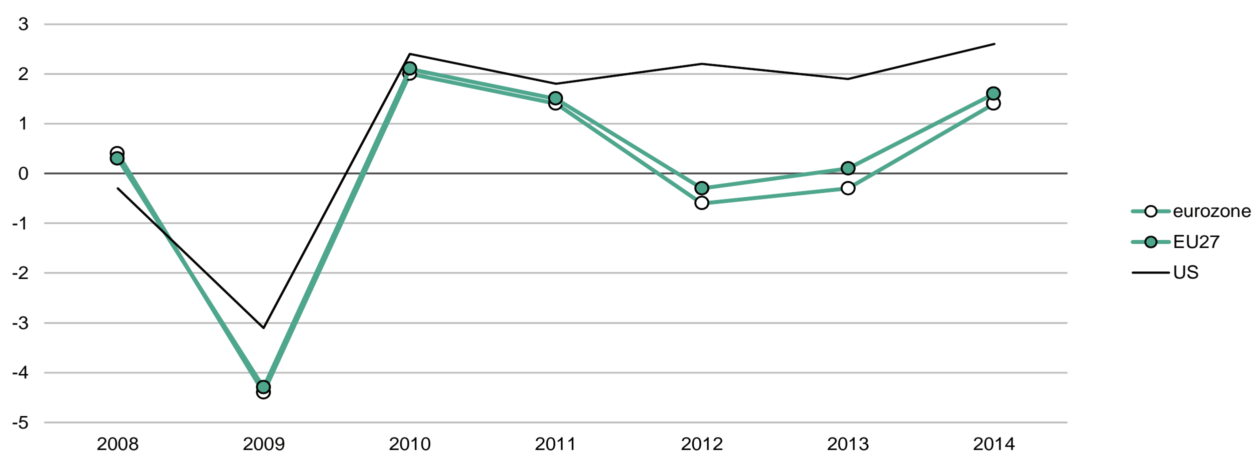
Economic developments: divergence and double-dip recession

Figure 1.1 Real GDP growth EU27, eurozone, US, 2008-2014(f), annual data



Source: own calculations based on AMECO (2012).

Europe's double-dip recession in contrast to the US

Both the European and the US economy experienced a deep slump in 2009, with the EU faring worse than the US. Yet the European economies managed to narrow their gap with the US in real GDP growth in 2010, whereas up until 2012 there was no differentiation on average between EU and eurozone member states (Figure 1.1).

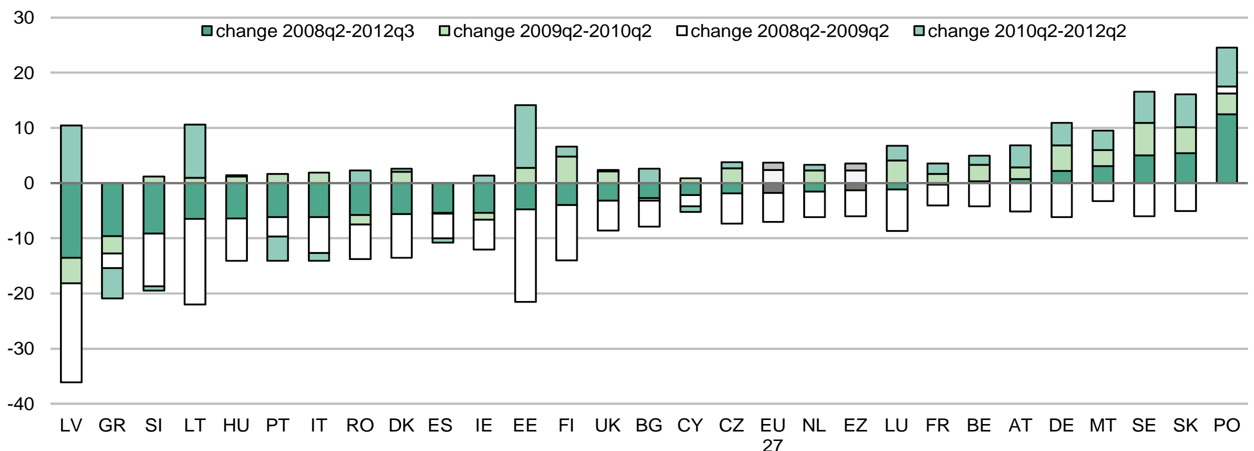
However, this situation changed from 2012 onwards. Following a slight slowdown in 2011, the US economy started growing modestly and is forecast to continue on that path until 2014 (see Figure 1.1). The European economies, on the other hand, in 2011-2012 experienced an accelerating drop in their real output growth, thus diverging from the US economy. 2010 was the year when the sovereign debt crisis broke out in the EU and when the dramatic attempts to rein in government budget deficits and public debt, by means of fiscal austerity, began. At the same time, there developed a slight divergence on average between the EU and the eurozone, with the member states of the latter experiencing a deeper slowdown.

The European Commission's latest forecasts (2012) suggest that positive output growth is on the cards from 2013 onwards; however, on the Commission's own admission, this projection is subject to substantial downside risks that are conditional upon the effective resolution of the eurozone crisis. Even if these downside risks were not to materialise – a big 'if' given current developments – the relative loss in output, both in absolute terms and in comparison with the US, especially following a recession as deep as in 2009, is substantial.

Moreover, even the optimistic version of these forecasts suggests that employment losses will continue well into 2014 in Europe (see Chapter 2). If productivity per worker were to grow by 1.2 % per year and population were to increase by 0.4 % per year – that is, their long-term averages before the crisis – output growth would not be sufficient to generate new jobs in Europe, let alone make up for the losses incurred since the onset of the crisis. This would add a further dimension of divergence in recovery between the European and the US economies, with implications for the long-term growth potential.

Economic developments: divergence and double-dip recession

Figure 1.2 Change in real GDP, 2008Q2-2012Q2



Source: own calculations using Eurostat (2012).

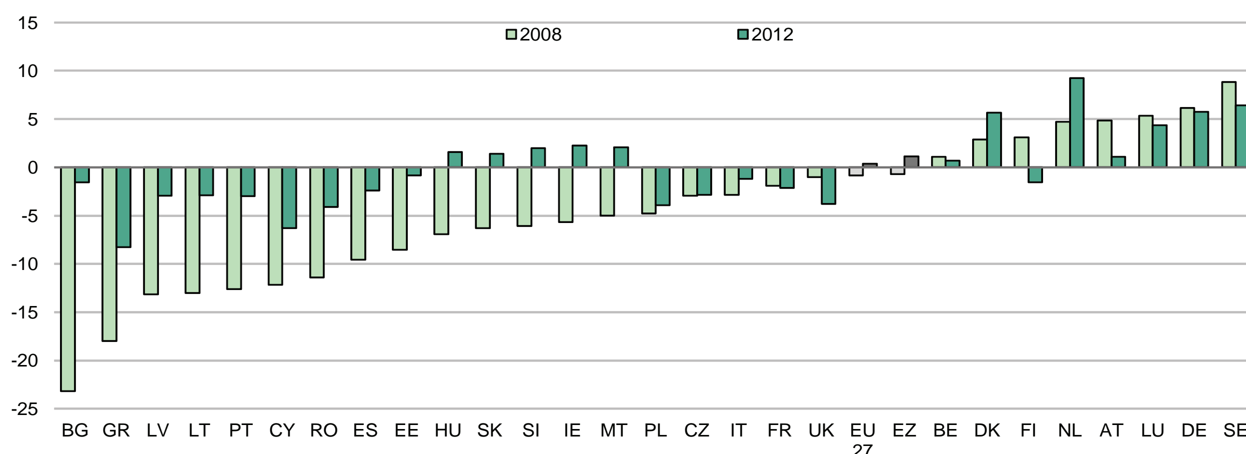
Divergence in real growth within Europe

The EU economy did not diverge only on average in comparison to the US, for divergent trends are concealed also beneath this average, i.e. within the EU. As seen in Figure 1.2, the losses in real output between the second quarter of 2008 – when the recession following the global crisis started – and the second quarter of 2012 have varied widely, and there have even been several member states, both within and outside the eurozone, whose real output actually increased during this period. While the average loss in output in the EU as a whole *and* within the eurozone was 1.8%, member states such as Latvia experienced a loss of nearly 15%, whereas many others lost three times as much output as this average. The biggest losers were member states that experienced either a balance-of-payments crisis outside the eurozone or a sovereign debt crisis within it (see also Chapter 2). The fact that, among these member states, most are either new member states (NMS) from Central and Eastern Europe (CEE) or former 'cohesion countries' from within the EU15, suggests that any convergence in real per capita income that had been achieved during the earlier years of EU membership has at best stalled if not been reversed (see ETUC and ETUI 2012: 19). On the other hand, among the member states whose output losses were smaller than average, or which experienced positive growth rates, one finds some of the richest EU/eurozone member states, but also Slovakia and Poland. Thus, we see that, contrary to hopes that EU accession would boost convergence for NMS12, the crisis has in many cases brought about divergence rather than convergence (see also Chapter 2).

The recession of 2008-2009 did not hit all member states to the same extent The divergent trends of that period were alleviated during 2009-2010 when coordinated fiscal stimulus policies were pursued across Europe (Figure 1.2). However, diverging trends in real output growth subsequently re-emerged between 2010 – when the sovereign debt crisis in the eurozone started and the switch to austerity policies took place – and 2012. On average the EU/eurozone's real GDP grew by 1.3-1.4 % during that period. However, the member states most hit by the debt crisis – Greece, Portugal, Italy, Spain – saw output losses that ranged from almost double to more than four times these rates. On the other hand, the Baltic States, which experienced some of the biggest losses in output after 2008, have experienced a strong growth rebound since 2010, which nevertheless has not completely made up for their earlier losses. Other eurozone member states, such as Germany, Austria and Slovakia, have managed to recover the output growth losses of 2008-9. Poland is the only EU member state not to have suffered any real losses in output growth since 2008.

Economic developments: adjusting economic imbalances

Figure 1.3 Current account balances (as % of GDP) EU27, 2008, 2012(f)



Source: AMECO (2012).

Asymmetric rebalancing of external positions/ current account imbalances

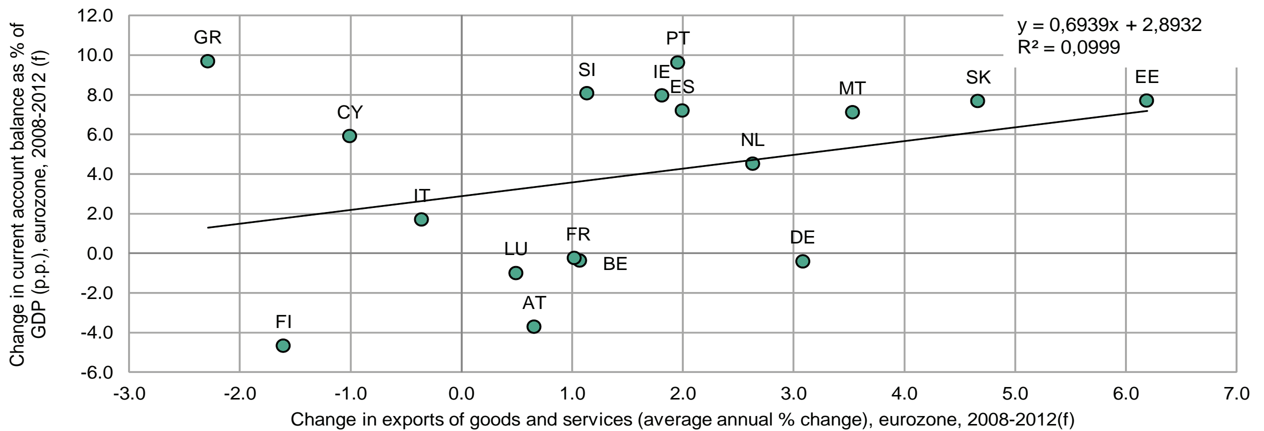
The divergence in macroeconomic developments between 1999 and 2008 manifested itself in sizeable current account imbalances. Given that, as Figure 1.3 shows, the current accounts of the eurozone and of the EU27 as a whole have remained almost in balance, the imbalances among member states reflected mostly divergent economic developments within the EU/eurozone rather than with regard to the rest of the world. Figure 1.3 also shows that the variation in external positions, that is, in current account balances, of EU member states was substantially reduced between 2008 and 2012, with most of the adjustment having been borne by those member states which found themselves experiencing current account deficits. In that sense, the divergence in current account balances has been reduced since the onset of the crisis. The interesting question, however, is how this result has been achieved.

Current account balances are often interpreted as reflecting the difference between a country's exports and imports, with deficits indicating higher imports than exports. It follows that an improvement in competitiveness (that is, the real exchange rate or the relative prices) of an economy could, other things being equal, lead to a decrease in current account deficit. Within the eurozone, the efforts of member states to rebalance their current account deficits have thus involved a strategy of 'internal devaluation', that is, the slowdown in their wage and price growth in an attempt to improve their competitiveness relative to member states with current account surpluses and thereby boost their exports relative to their imports.

In a world with rigid prices and nominal wages and, in the case of the eurozone, in the absence of a nominal exchange rate, improvements in competitiveness achieved through an 'internal devaluation' are typically painful, as they involve cuts in salaries and employment. They can, what is more, take time. The effectiveness of internal devaluation is also questionable when the strategy is followed by a large number of member states at the same time. On the one hand, competitiveness is a relative concept and therefore, when too many economies try to improve it against each other, ever greater efforts are required; on the other hand, attempts to achieve internal devaluation also take a toll in domestic demand, which in turn affects demand for imports, which are also the exports of other trading partners, often the countries which are trying to reduce their current account deficits through an export expansion. Moreover, such a strategy can undermine attempts at reducing government budget deficits because of the recession it is likely to generate. An alternative route to rebalancing current account deficits is to reduce the demand for imports by reducing domestic demand; or, as the other way of interpreting the current account balance goes, to increase domestic saving (public and private) over investment. This can be a no less painful and even less sustainable process than the internal devaluation option, except that it can sometimes be engineered relatively more quickly. Fiscal austerity measures contribute to its achievement.

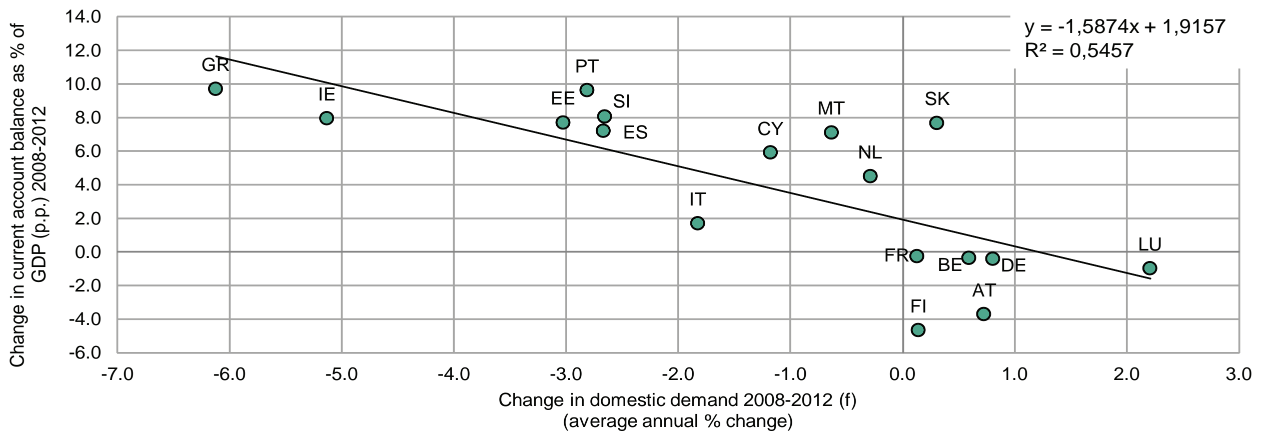
Economic developments: adjusting economic imbalances

Figure 1.4 Exports and the current account balance, eurozone member states, 2008-2012 (f)



Source: own calculations using AMECO (2012).

Figure 1.5 Domestic demand and the current account, eurozone member states, 2008-2012



Source: own calculations using AMECO (2012).

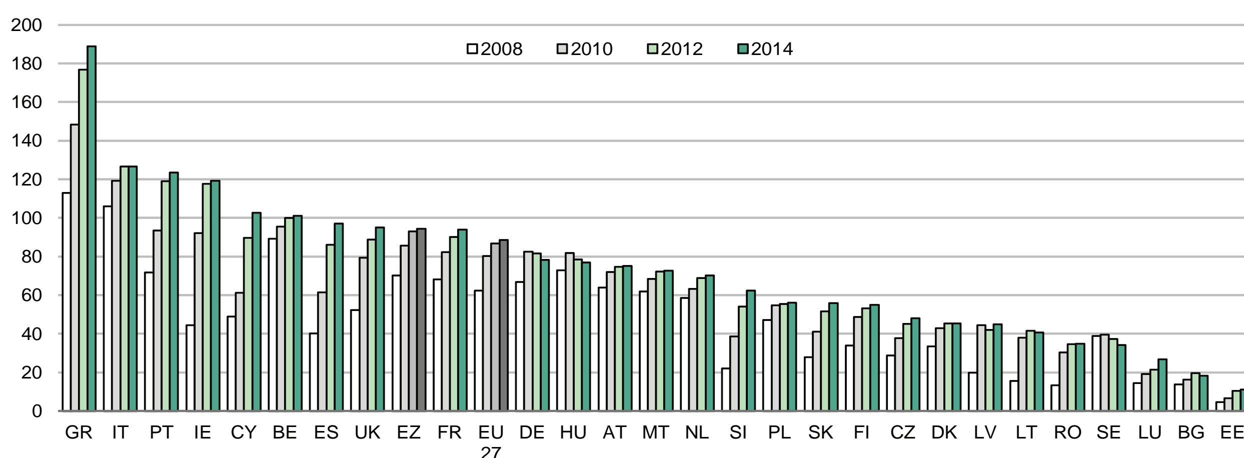
Domestic demand rather than exports accounting for correction of imbalances

Figures 1.4 and 1.5 suggest that domestic demand developments accounted for a far larger part of the adjustment in current account imbalances within the eurozone – and especially in member states with current account deficits – between 2008 and 2012 (estimated values), than did changes in export performance. The respective associations for the EU member states (not illustrated here) suggest that actually exports accounted for a higher but still relatively small part of the current account imbalance than did developments in domestic demand.

This situation is actually not much different from what happened during the period 1999-2008 when divergence in domestic demand was a far more important factor for the rise of current account imbalances in the eurozone than was divergence in export performance (European Commission 2009: 27). While the extent of divergence in current account balances that was evident in 2008 has now been reduced, this adjustment process has taken place in ways that fuelled divergence in other real variables, most notably real output growth.

Economic developments: adjusting economic imbalances

Figure 1.6 Gross public debt as % of GDP in the EU27, 2008, 2010, 2012, 2014



Source: AMECO (2012).

Sovereign debt and banking crises: the lethal feedback loop

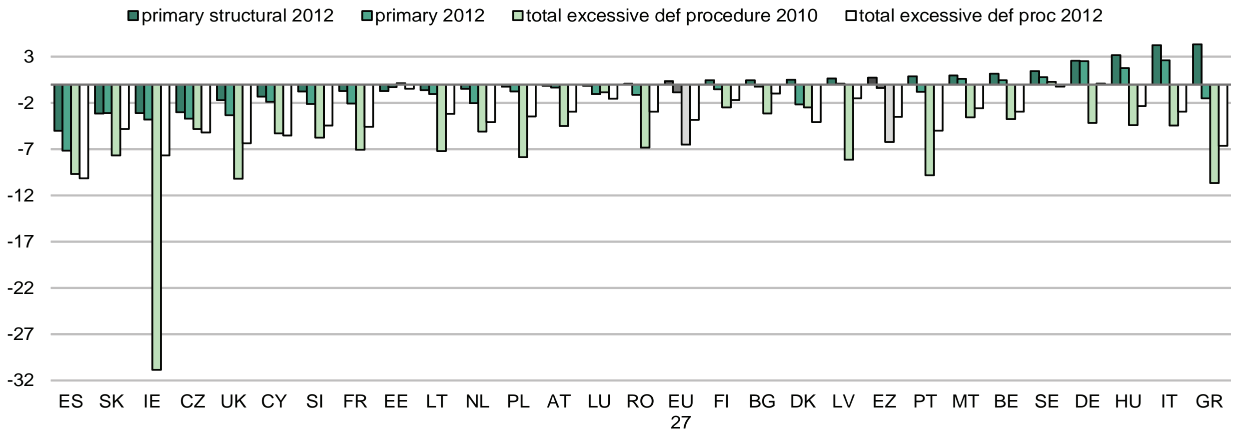
The public finances of individual countries, as measured by the gross-debt-to-GDP ratio, started deteriorating soon after the onset of the global financial crisis in 2008, partly due to the recession that followed it and partly due to the fiscal stimulus measures undertaken in 2008-2009 to counteract it. In the EU, from 2010, the policy direction changed towards fiscal austerity. However, this deterioration was not evenly distributed. Member states that saw the biggest increases in their gross-debt-to-GDP ratios are also those which saw the worst reductions in their real output growth, most notably Greece, Ireland, Portugal, Spain, Cyprus, Slovenia, but also the UK, Romania, Latvia and Lithuania. These were also the member states that had faced sovereign debt and/or balance-of-payments crises in the markets since 2007 and which, in response, had pursued the toughest austerity programmes, whether or not as a condition for receiving financial help from the EU and the IMF (see also Chapter 2). Of these, only Greece, before the crisis started and the austerity policies were adopted, had a debt/GDP ratio that was high enough to have a potentially adverse effect on output growth (cf. Reinhart *et al.* 2012).

The debt-to-GDP ratios are forecast to increase or remain at higher levels in 2014 in all but a handful of countries, namely Germany, Hungary, Lithuania and Sweden, but, even in these latter cases, any decrease is likely to be small. Rather than boosting confidence in the sustainability of public debt, austerity policies and their adverse effects on real output growth have undermined it, leading to persistently higher debt-to-GDP ratios.

The deep recession experienced by several member states and the worsening sovereign debt crisis were further reinforced by and fed into the crisis of banking systems in Europe. The value of assets of banks, especially in affected countries, was reduced by the combination of recession – which made numerous loans unserviceable – and the sovereign debt crises, given that banks are among the biggest holders of government bonds of the country in which they are based. These losses in asset value generated concerns about the capacity of banks to operate on a sound basis. The potential need for bank bail-outs would put further pressure on troubled governments' balance sheets, thus further worsening expectations about the sustainability of their public finances. Moreover, the exposure of banks to the potentially unsustainable debt of sovereigns was not restricted by national borders. Thus the sovereign debt crisis generated problems in banks across Europe. In this way, with the spread of the sovereign debt crisis, the lethal loop between sovereign debt and banking systems came more prominently to the fore in 2012.

Economic developments: adjusting economic imbalances

Figure 1.7 Government budget deficits: Total, primary (excl. interest) and primary structural (cyclically adjusted excl. interest) (% of GDP) EU27, 2012



Source: AMECO (2012).

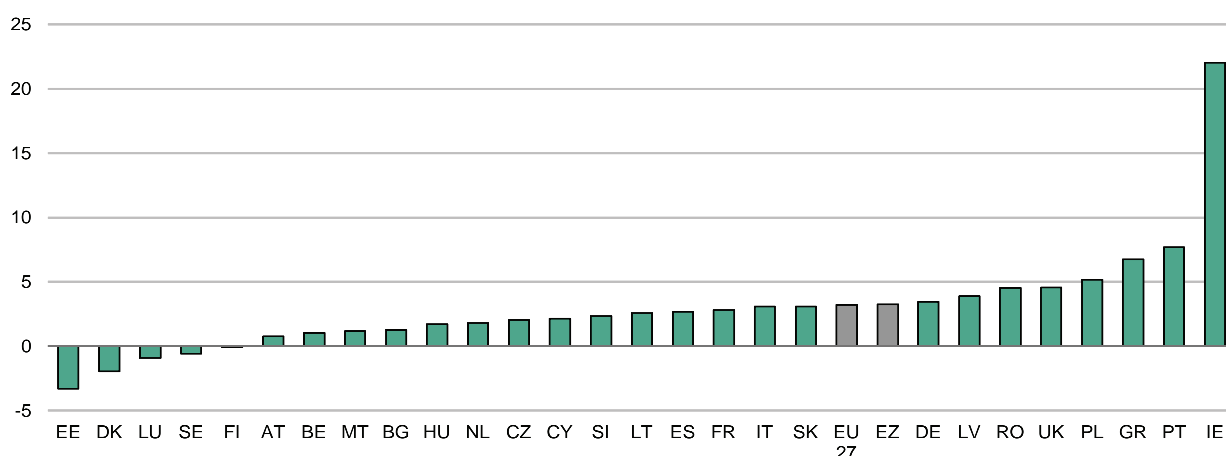
Austerity undermined public finances

The reversal of government budget deficits, which soared after 2008-9, has been a painful process since 2010, especially for those member states whose governments faced sovereign debt crises in the financial markets. It was in these countries that austerity policies were most severe and that, in most cases, they deepend the recessions that undermined the purpose of fiscal consolidation. As Figure 1.7 above shows, Greece, Italy and Portugal, that is, countries which undertook some of the most sweeping austerity measures, had among the biggest government budget surpluses if the interest payments, which soared due to the crisis, are excluded and the effects of recession on government revenues and expenditures are netted out. Yet the total budget balances of their governments are expected to register some of the highest deficits in 2012. This discrepancy underlines the detrimental effects of austerity on real output growth.

Recent research by the International Monetary Fund (IMF 2012) has suggested that the adverse effects of fiscal austerity on economic activity (as summarised by the 'fiscal multiplier') were likely to be much greater than had been assumed when the adjustment programmes were designed, especially for those member states that received financial support in exchange for conditionality programmes. The reasons for these larger-than-expected effects are to be found in the set-up of the eurozone but also in the specific circumstances of the crisis. The effects of fiscal consolidation on economic activity in the short to medium run are likely to be less adverse if fiscal austerity measures can be combined with an accommodating and effective monetary policy that allows interest rates to fall. In the eurozone this has not been possible, both because monetary policy is not set depending on the needs of specific member states and because interest rates have been very close to zero; as such, there was no scope for large reductions. Moreover, the interconnection between sovereign debt and banking crises has meant that the growth of credit from banks to households and firms, especially in the member states that have been most affected by these crises and recession, has been heavily constrained. Therefore, in addition to undermining fiscal consolidation, austerity policies have also been driving divergence in real output growth in the eurozone.

Macroeconomic policy responses

Figure 1.8 Change in structural government balance (as % of GDP-excl. interest payments), EU27, 2010-2012(f)



Source: AMECO (2012).

Uncoordinated fiscal austerity

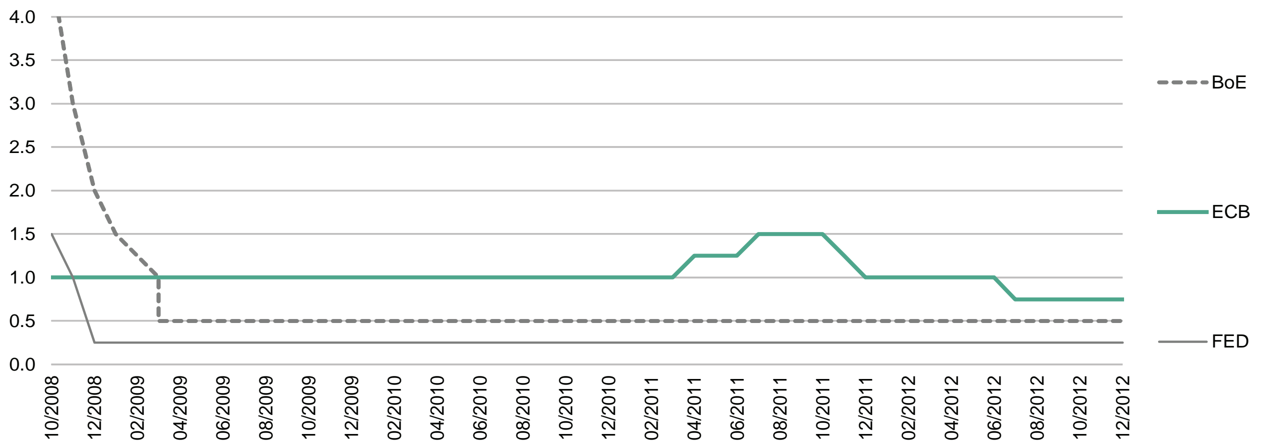
Divergence was observed in the stance of fiscal policies within the EU and the eurozone in particular. Figure 1.8 shows the change in primary structural government balance (that is, the difference between revenues and expenditure excluding interest payments once the business cycle, that is, the state of the economy, has been taken into account) in the EU27 between 2010 and 2012. The change in this balance can be thought of as an indicator of discretionary fiscal policy stance in the EU27. We see that, on average both in the EU and the eurozone, discretionary fiscal policy stances were tightened, that is, public spending was cut and taxes were raised. In other words, fiscal policies have been tilted towards (financial) austerity in spite of the double-dip recession facing the EU.

Beneath these averages, we also see that only a handful of member states did not tighten their discretionary fiscal policies, namely Estonia, Denmark, Luxembourg, Sweden and Finland. eurozone member states which received financial support in exchange for conditionality programmes of fiscal and current account adjustment tightened their policies the most, along with the UK, Romania, Latvia and Germany, which tightened them by more than average in the EU. Of these, Romania and Latvia have also been under EU and/or IMF surveillance. On the other hand, in the UK and Germany the change in policy stance has been dictated more by the views of the respective governments which adhere to fiscal rectitude in spite of macroeconomic conditions than by market pressures, especially in Germany. Other large EU economies, such as France, Italy, Spain and Poland, have also tightened their discretionary fiscal policy effort almost as much as the average in the EU.

These developments, when considered together with the real output growth pattern in the EU, are reasons for concern about the appropriateness of the European response to the sovereign debt crisis in the eurozone. For one thing, member states like Spain and Italy have been drawn into the crisis even though their fundamentals at its onset did not suggest that they were insolvent. For another, these stances reveal the absence of a sense of coordination across individual member states' fiscal policy efforts, so that those whose governments have not been facing problems of confidence in the markets use their fiscal policies with a view to stimulating aggregate demand in the area as a whole. As Figures 1.6 and 1.7 suggest, the aggregate EU27 and eurozone debt and government-budget-deficit-to-GDP ratios are not excessively high, especially given the double-dip recession experienced in the area. In other words, the public finances of the EU and the eurozone as a whole are not unsustainable. Yet as these graphs also suggest, the problem loads are unevenly distributed across member states and this would appear to make coordination of policy stances ever more important both for overcoming the crisis and for doing so in a way that avoids further divergence in output growth.

Macroeconomic policy responses

Figure 1.9 Central Bank policy rates, ECB, BoE, FED, 2008-2012



Source: Own compilation based on Bank of England, European Central Bank, Federal Reserve.

Monetary policy: masterstrokes or muddling through?

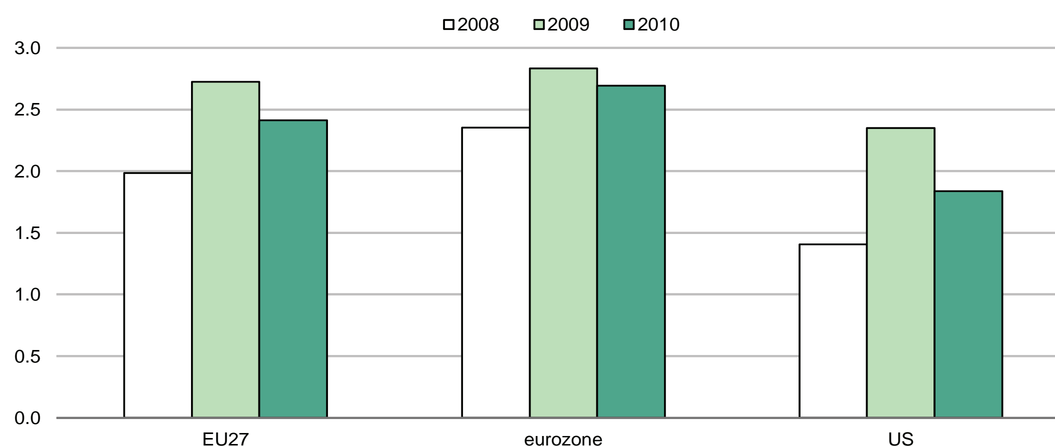
The European Central Bank (ECB) undertook a series of policy initiatives towards the end of 2011 and in 2012. In autumn 2011, it announced the launch of its Long-Term Refinancing Programme towards banking institutions of the eurozone. The move was intended to provide means of alleviating the sovereign debt crisis by channelling liquidity to the banks which could then buy distressed government bonds and thereby help reduce the spreads in interest rates of the affected sovereign bonds over those of Germany. Although there were signs of effectiveness, in practice this move intensified the vicious link between sovereign debt and banking crises as the sustainability of public debt in several countries did not improve (see above in this chapter).

In the summer of 2012, Mario Draghi announced in public that the ECB would do 'whatever it takes' to avert the dissolution of the eurozone as a result of a government defaulting on its debt and re-introducing its own currency. A condition for that would be that the government facing distress in the sovereign debt markets would have to apply for support from the ESM and sign up with the EU, the ECB and the IMF for a conditionality programme in exchange. This move also appeared to have impressed sovereign debt markets. However, to the extent that the EU approach of uncoordinated fiscal austerity continues to dominate the philosophy of the conditionality programmes attached to EMS support, and as long as the feedback loop between sovereign debt and banking crises is not broken by the creation of an adequate banking union, the medium-term effectiveness of the ECB's commitment to averting the breakup of the eurozone is questionable.

Last but not least, in July 2012, there was a reduction in the bank's main refinancing rate from 1% to 0.75%, which nevertheless kept it above the respective main rates of both the Bank of England and the US Federal Reserve (FED; see Figure 1.9).

Looking ahead: is the observed divergence likely to dissipate?

Figure 1.10 Long-term real interest rates (deflator GDP), EU27, eurozone, US, 2008-2010



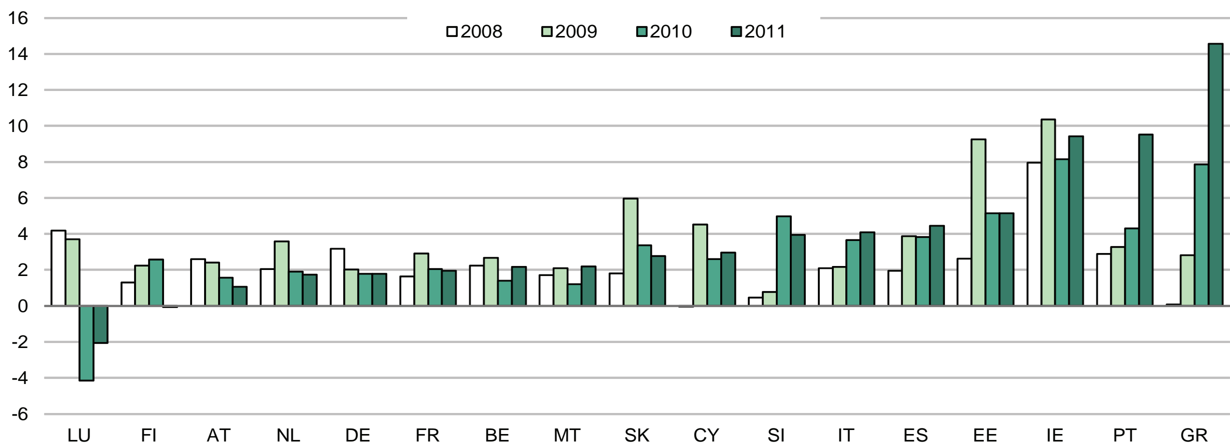
Source: own calculations using AMECO (2012).

Long-term real interest rate divergence: Europe vs. the US

As Figure 1.10 shows, long-term real interest rates remained on average higher in Europe than in the US between 2008 and 2010, as they also declined by less between 2009 and 2010. These interest rates are important determinants of investment decisions in an economy and, by implication, of its growth prospects and public finance sustainability, with higher interest rates having a detrimental effect. They are calculated using the interest rate on long-term government bonds adjusted for expected inflation. Given the advanced degree of financial integration, divergence in real interest rates among financially integrated countries reflects, to a large extent, divergent financial risk premiums across them. Common underlying causes of the size of such premiums are the investors' perceived risk of default, in turn a function of the perceived sustainability of a government's fiscal position, expected market volatility and uncertainty about future inflation developments, at the root of which we may also find unsustainable debt paths. Given these factors, the difference between the EU27 and eurozone averages in 2010 is even more striking and a sign of divergent developments that are likely to last, with eurozone member states being on average more adversely affected than the EU. Although the sovereign debt crisis did not emerge in the eurozone until early 2010, the illustrated long-term real interest rates suggest that the EU's approach to resolving it was already not convincing at that time in terms of effectiveness. At the heart of this difference is the fact that the sovereign debt and banking crises have mostly affected the eurozone, while it has also been the failure to tackle these crises effectively within the eurozone that has fuelled the divergence in long-term real interest rates with the EU27. Rather than being a source of stability, eurozone membership has, in actual fact, generated more turbulence for its members under the current circumstances.

Looking ahead: is the observed divergence likely to dissipate?

Figure 1.11 Long-term real interest rates (deflator GDP), eurozone, 2008-2011



Source: own calculations using AMECO (2012).

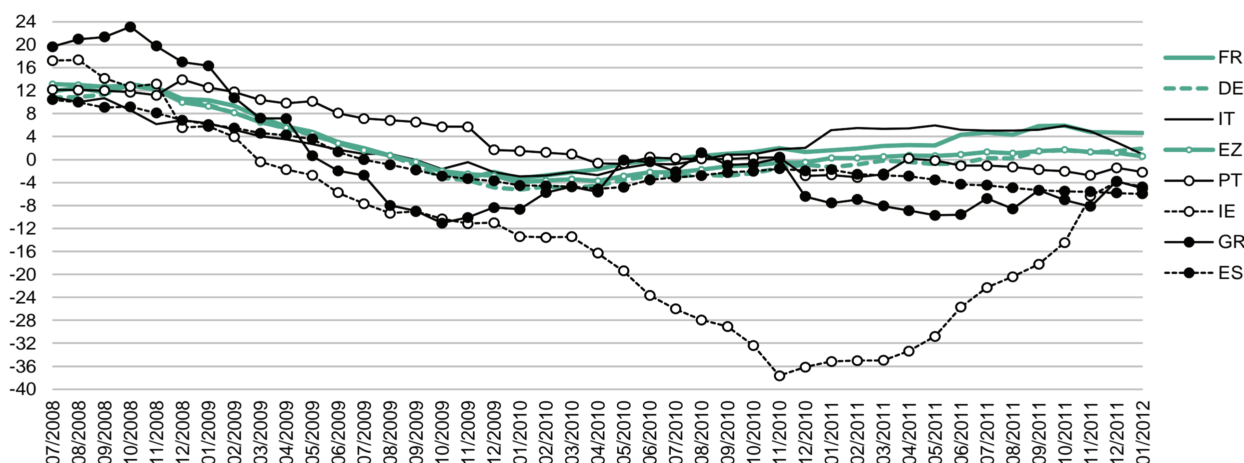
Eurozone real interest rate divergence continued

When we look beneath the eurozone average, we also see a large divergence in long-term real interest rates among member states. Long-term real interest rates rose most in the eurozone periphery, in those member states that have been (on the verge of) facing sovereign debt crises, namely Greece, Portugal, Ireland, Spain, Italy, but also Slovenia. In all these countries, with the exception of Ireland, the upward trend in interest rates continued in 2011, that is, after the EU's approach to dealing with the crisis had been revealed. This development is a reversal of what had happened up to 2008. As is well known, divergent inflation rates between the core and the periphery had led to lower real interest rates in the latter, in spite of the common monetary policy of the ECB. This is illustrated in Figure 1.11 (2008 data). However, after the onset of the crisis, this situation was reversed to reflect the heightened market perceptions of the risk of sovereign default and currency conversion (that is, of a country deciding to leave the eurozone) in the periphery member states that were affected. In fact, this reversal has led to a far more dramatic divergence pattern in long-term interest rates and the implications of such divergence in terms of demand and output growth are not difficult to grasp. Up until 2008 divergence had been much more limited and yet had led to substantial current account imbalances which were largely accounted for by divergence in domestic demand conditions (European Commission 2009).

This is a clear sign that the policy responses to the eurozone crisis are unlikely to stem the divergent trends in output growth that were documented in a previous section, as they have failed to fundamentally dispel fears about the break-up of the euro or to restore confidence in the sustainability of the public finances of several member states and the solidity of the banking systems in the eurozone. On the one hand, the insistence on strategies of unabated fiscal austerity across the area in the face of fast spreading faltering macroeconomic conditions and the unbalanced focus on attempts to prove fiscal rectitude as a means of restoring market confidence and avoiding issues of moral hazard that could follow from bail-outs and, on the other hand, the uncoordinated, unilateral approach to re-balancing current account imbalances through strategies of 'internal devaluation' in the eurozone, have perpetuated the economic slump and deteriorated expectations about debt sustainability.

Looking ahead: is the observed divergence likely to dissipate?

Figure 1.12 Monetary Financial Institutions loans to non-financial corporations



Source: OECD (2012).

The breakdown of the ECB's monetary policy transmission mechanism

Moreover, strong political resistance to the creation of an effective banking union, on the grounds that it would imply the pooling of banking risks at the eurozone level and the loss of national control over banking systems within the EU, has further reinforced the lethal feedback loop between sovereign and banking crises. This loop has also contributed to the breakdown of the ECB's monetary policy transmission mechanism. As the access of banks to liquidity in the eurozone is no longer determined by the ECB's interest rate policy alone, but rather by their perceived viability by market actors, which in turn is linked to their exposure to the sovereign debt of the country in which they are based, and as the collapse of confidence in the banking systems of several periphery member states has led to massive outflows of savings towards banking institutions in the EU core, the ECB's policy initiatives become ever less effective. This in turn contributes to increasing the size of fiscal multipliers, making the effects of fiscal austerity, especially in the most ill-affected member states, even graver, because any monetary policy tools, which have anyway been operating near the zero lower bound, become even weaker as they do not affect liquidity across the eurozone, whereas households and firms become even more credit-constrained. As Figure 1.12 above shows, there has been a substantial divergence in the flow of loans from monetary financial institutions to non-financial corporations between core and periphery member states.

Conclusions

Unresolved eurozone crisis fuelling divergence

The developments presented in this chapter suggest that the current economic crisis which has hit, primarily, the eurozone, and the policies launched in response to this crisis, have been driving substantial divergence trends within the eurozone itself and beyond, in particular with regard to real output growth, a variable which remains crucial for promoting fundamental objectives of European integration such as economic progress, increased economic and social cohesion, and the creation and maintenance of an economic and monetary union. Due to the close interdependence with the rest of the EU member states, these trends are likely to be even stronger between eurozone insiders and outsiders.

Oversights in the initial institutional construction of the eurozone, such as the absence of a fiscal and a banking union, and failure to foresee the potential implications of certain risks inherent in its operation, such as the persistent build-up of current account imbalances, the destabilising effects of a single monetary policy, and the existence of a feedback loop between sovereigns and banks, all of which operate in a cumulatively destabilising fashion, have fuelled the current crises, while ill-conceived policy responses have contributed to their expansion, ultimately jeopardising the very existence of the single currency.

It has now been documented that fiscal austerity could, and should, have been expected to have far more adverse effects on growth than originally calculated, while the efforts to rebalance current account imbalances seem to have relied more on depressing economic activity in those member states with deficits than on expanding these countries' export performance. On the other hand, it has been acknowledged, at least in some quarters, that, due to the increased integration of banking systems in Europe, the resolution of banking crises should not rest with national governments but, instead, should be pooled at the supranational level.

While, at least at the level of rhetoric, some steps have been taken to address these shortcomings, the responses so far leave a great deal to be desired. Fiscal policies and any attempts to coordinate them are still fashioned on the assumptions that what is necessary to resolve the current and avoid a future crisis is stronger adherence to fiscal prudence and that tackling questions of 'moral hazard' in exchange for supporting troubled governments is more important than taking steps that would decisively help member states put their public finances on to a sustainable path and end the crisis once and for all. Moreover, rather than coordinating the re-balancing of current account imbalances across member states with deficits and surpluses, unilateral strategies are pursued. Last but not least, while it has been acknowledged that a banking union is necessary, the proposals put in place suggest a merely curtailed version of what would be an effective set-up, entailing, as they do, transfer to the ECB of control of only a part of banking institutions, while omitting all provision for a pan-European guarantee of deposits.

As we have seen in this chapter, inadequate responses have led to prognostication of a breakup of the eurozone. Predictions along such lines have catastrophic effects for the economies of the member states that have been facing debt crises, as they raise long-term real interest rates and dampen investment, even in the face of improved fundamentals, while at the same time contributing to a breakdown of the single monetary policy's transmission mechanism and essentially weakening, if not actually cancelling out, any effects it can have in those eurozone economies that most badly need them. Putting the right policy responses in place is therefore essential for avoiding further divergence in Europe and rescuing the project of European economic integration itself.