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Discussion Paper

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Bailouts in the euro crisis: Implications for the aftermath of the COVID-19 pandemic

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Introduction

The year 2020 is exceptional and will long be remembered. The corona pandemic brought economic life in the euro area temporarily to an abrupt halt. It is still uncertain on what path and to which degree economic activity will return to the previous normal. As a result of the lockdown in response to the pandemic, economic activity and tax revenue were significantly lowered. Minimizing the economic damage will require fiscal support including sizable fiscal stimulus packages. Although the precise fiscal measures are not yet fully specified, one effect is certain, we will see a significant increase in public deficits and debt.

2020 also marks the tenth anniversary of an important milestone for the European Union (EU), major reforms of the euro area architecture were initiated in 2011, at that time, in response to the European debt crisis. In the course of one year, starting May 2010, Greece, Ireland and Portugal sought financial assistance from the EU as they had lost access to financial markets. They were the first to enter Economic Adjustment Programs (EAP) in exchange for financial help. Prolonged domestic demand shocks in each of these countries had caused significant economic imbalances. While origin and duration of these shocks were heterogeneous, the symptoms were similar. Current account imbalances and deteriorating competitiveness in comparison to their main trading partners became visible early on without causing sufficient concern.[1] The root cause for this oversight was the original euro area framework centered on the Stability and Growth Pact (SGP) which

1 Mackowiak, B., Mongelli, F. P., Noblet, G., and Smets, F. (2009), The Euro at Ten - Lessons And Challenges. European Central Bank.

narrowly focused on the sustainability of fiscal policy. The obvious deficiencies of the original euro area architecture forced major reforms which are still far from complete.[2]

This paper provides a summary of the national developments that led to Greece, Ireland and Portugal needing financial assistance from the EU and ultimately the euro crisis. Weak spots and gaps in the original euro area architecture facilitated, if not enabled, the buildup of sizable disequilibria. The Great Recession triggered but did not cause the euro crisis. Today, the euro area has not fully recovered from the crisis. On average public debt is still above the pre-euro crisis level, see Fig. 2. The economic impact of the COVID-19 pandemic will have the potential to reignite the euro crisis if member states do not move swiftly to complete the reform of the euro area architecture to make it more shock-proof.

Regarding the exceptional support package to help the EU member states to come out of the plunge caused by the Coronavirus which was agreed upon by EU heads of state and government on 21 July 2020, it is yet to be seen whether the recovery program along with respective elements of the multi-annual EU budget will be ratified without delay. Once this is done, beneficiary countries will have to come forward with meaningful strategies as to implement the support program in areas where additional funds are most useful to achieve the desired economic recovery.

2 Bierbrauer, C. (2020), The Juncker Commission's contribution to the completion of the European Economic and Monetary Union: An early appraisal. IEER Working Papers 117, Institute of Empirical Economic Research, Osnabrück University.

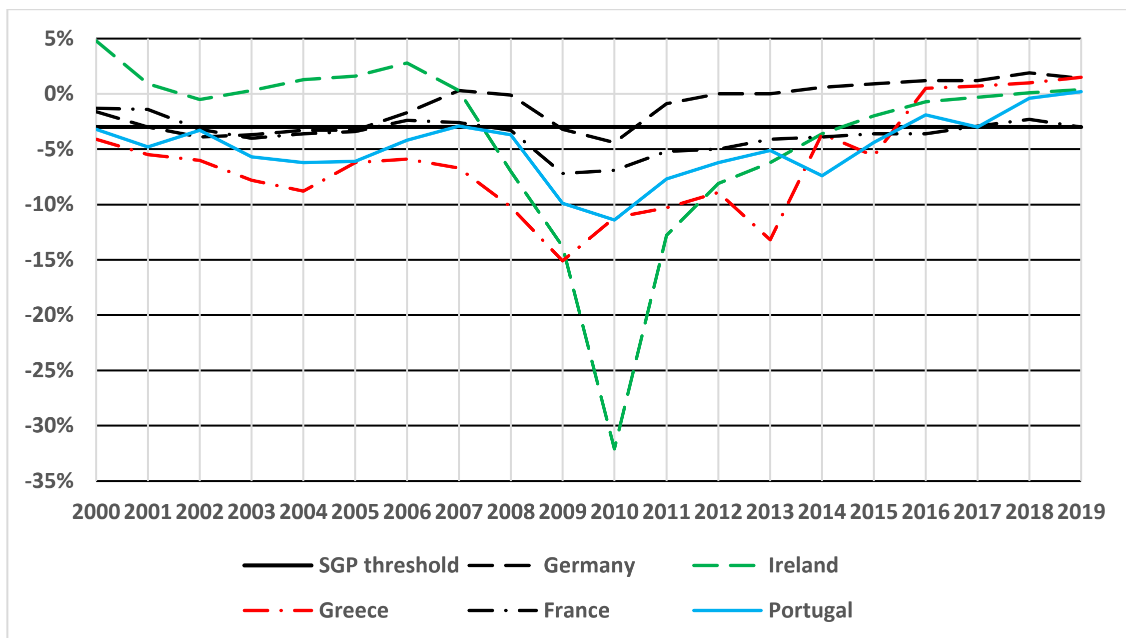

Figure 1. Government deficit/surplus for France, Germany, Greece, Ireland and Portugal measured as a percentage of gross domestic product, annual data. France and Germany, the two largest economies of the euro area, are added for comparison.

Source: Own presentation based on Eurostat data, online data code: gov_10dd_edpt1

Run up to the euro crisis

In 2008, the Great Recession hit the euro area. To cushion the impact, national fiscal stimulus packages as well as a European response, the European Economic Recovery Plan were enacted.[3] The euro area has no fiscal sovereign, member states decide fiscal policy at the national level. Thus, they require sufficient room for fiscal maneuver to conduct economic stabilization. Moreover, as the prudential supervision of the financial sector was also allocated at national level, before the reforms of 2011 and the years thereafter, the available fiscal space would also have to be sufficient to backstop the national financial system in case of a crisis.

3 European Commission (2008), A European economic recovery plan. Commission of the European Communities, COM (2008) 800.

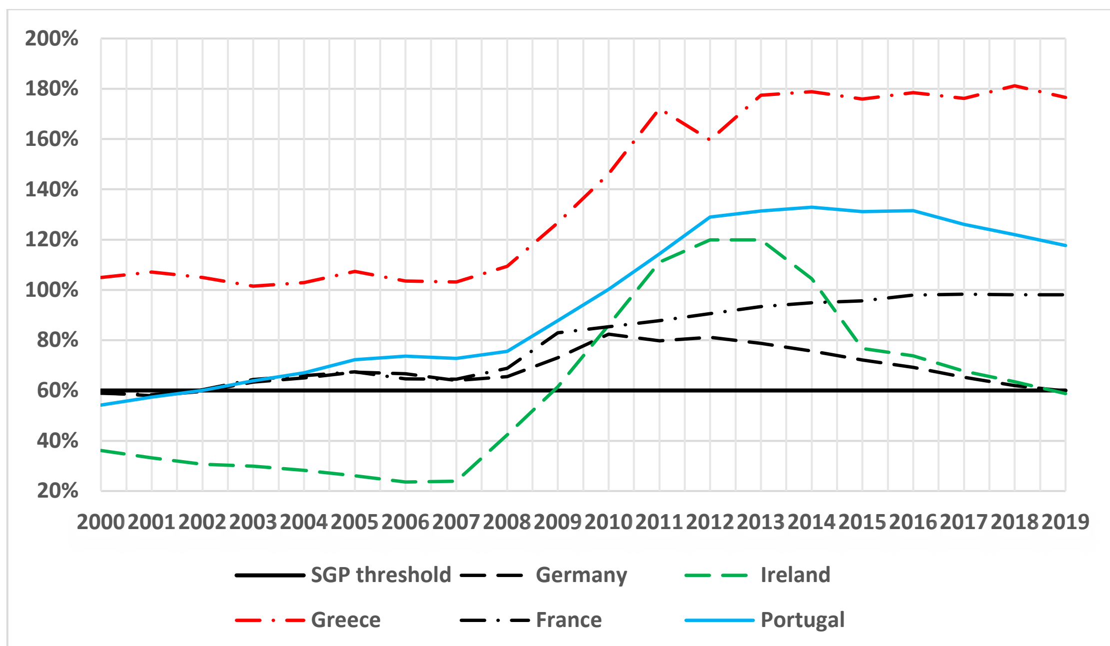

Figure 2. Public debt for France, Germany, Greece, Ireland and Portugal measured as a percentage of gross domestic product, annual data. France and Germany, the two largest economies of the euro area, are added for comparison.

Source: Own presentation based on Eurostat data, online data code: TIPSGO10.

The member states of the European Union (EU) were aware of the problem when negotiating the architecture of the euro area. The original SGP was agreed upon to guarantee the national ability to conduct fiscal stabilization and adequately respond to financial crises.[4] The original SGP's fiscal rules set upper limits for national government debt and annual government deficit, of 60 % and 3 % of national gross domestic product. Moreover, it introduced the no-bailout clause which prohibited the mutual guarantee of national debt among member states. This clause was intended to enforce fiscal discipline by imposing prohibitively huge costs in case a member state failed to adhere to the common rules. However, the SGP was never enforced and did not effectively limit neither public debt nor budget deficits, see Figs. 1, 2.

In fact, the Great Recession started as a financial crisis in 2007. Excessive risk taking led to existence-threatening losses of major banks in all member states. Euro area private banks interact in their refinancing operations with

4 Eichengreen, B. and Wyplosz, C. (1998), The Stability Pact: more than a minor nuisance? Economic Policy, 13(26):66-113.

the ECB. They are required to maintain stocks of safe assets, i.e. top-rated public debt, as collateral for these transactions. The euro area does not issue common debt titles. Thus, there is no common safe asset available. Instead of holding a balanced portfolio of public debt issued by euro area members, private banks show a home bias. They mostly hold debt of their national sovereign. According to the ECB[5], one important reason for such behavior is the fact that it accepts any public debt issued by a euro area member as collateral.

In 2007, the responsibility for the prudential supervision of the financial system was allocated to the national level leading to a lack of impartiality.[6] National governments had to support private banks that needed assistance to countervail their losses.[7] Fiscal sustainability was already under stress in the euro area. For some countries, additional debt issued to finance bank rescue packages seemed to be the straw that broke the camel's back. Interest rates on public debt increased, implying further losses for investors with respective inventories. Because of their home bias, the banking sectors in already highly indebted countries where hit particularly hard increasing their capital needs and further straining the sustainability of fiscal policy. This vicious circle is known as the sovereign-bank doom loop.

The common consensus is that the lack of a common safe asset in combination with high levels of public debt proved to be a crucial weak spot of the euro area architecture.[8] The sovereign-bank doom loop threatened several countries' access to financial markets including Greece, Ireland, Italy, Portugal and Spain. From May 2010 to April 2011, Greece, Ireland and Portugal were no longer able to issue public debt at sustainable interest rates. We focus on these countries as they were the first countries that agreed to

5 European Central Bank (2012), A fiscal compact for a stronger economic and monetary union. Monthly Bulletin, pp. 79-94.

6 Gerlach, S., Schulz, A., and Wolff, G. B. (2010), Banking and Sovereign Risk in the Euro Area. CEPR Discussion Papers 7833, C.E.P.R. Discussion Papers.

7 Wyplosz, C. (2014), The Eurozone crisis: A near-perfect case of mismanagement. Economia Marche/Journal of Applied Economics, 0(1):1-13.

8 Baldwin, R. and Giavazzi, F., editors (2015), The Eurozone Crisis: A Consensus View of the Causes and a Few Possible Solutions. VoxEU.org Book, London: Centre for Economic Policy Research.

“Economic Adjustment Programs” in exchange for financial help. The EAPs were agreed between them, the ECB, the International Monetary Fund (IMF) and the European Commission, henceforth the Troika.

From a layman's perspective, their situation seemed almost identical as they shared several crisis symptoms. In each country, the run-up to the crisis was characterized by real wage growth outpacing productivity growth, current account deficits, consequently, increasing external debt and loss of competitiveness as compared to their main trading partners.[9] However, the underlying economic shocks that caused these symptoms had little in common. Joining the euro area had led to a decrease in real interest rates in each of the three countries. According to the predictions of textbook models of international macroeconomics[10], national agents use such an opportunity to borrow and invest which increases productivity. The accumulated external debt can be repaid reaping the fruits of these investments. This perspective explains why the increased external debt of several euro area countries raised only little concern.[11] Simple models abstract from the distinction between traded and non-traded goods. Any investment improves productivity in the sector of tradable goods as no other sectors exist.[12] In more complex models, and in the real world, investment takes place in the tradable or, the less productive, non-tradable sector. External borrowing might be also used for private or public consumption which does not improve productivity. Even worse, if external borrowing is used to finance wage increases in the non-tradable sector, such as the public administration or the construction sector, it will have the opposite effect. As the tradable sector competes with these

9 Chen, R., Milesi-Ferretti, G. M., and Tressel, T. (2013), External imbalances in the eurozone. Economic Policy, 28(73):101-142.

10 Obstfeld, M. and Rogoff, K. (1996), Foundations of International Macroeconomics. Cambridge, Massachusetts: The MIT Press.

11 Mackowiak, B., Mongelli, F. P., Noblet, G., and Smets, F. (2009), The Euro at Ten - Lessons And Challenges. European Central Bank.

12 Giavazzi, F. and Spaventa, L. (2011), Why the current account may matter in a monetary union. Lesson from the financial crisis in the Euro area. Working Papers 426, IGIER (Innocenzo Gasparini Institute for Economic Research), Bocconi University.

sectors on the labor market, credit-financed consumption has the undesirable effect of driving up the unit labor costs in all sectors of the economy.

In the run up to the crisis, Greece experienced a credit-financed domestic demand boom driven by private and public consumption. The government borrowed to finance an oversized public sector as well as increased spending on wages and pensions in the public sector which drove wages in the private sector up as well. Overall, the administration of the country was characterized by inefficiencies. Corruption and tax evasion were endemic and previous Greek governments either had no interest or were unable to provide sound and reliable statistics.[13] As a result of overoptimistic expectations regarding future revenues, Greece failed to deliver budgets that met its obligations under the SGP. The 3 % target for the public deficit was never met and public debt was well above the 60 % threshold and on a steady upward path, see Fig. 1. In 2010, a newly elected Greek government revised the predicted paths for government debt and deficits admitting that past official statistics were cooked. In response to the shock, investors demanded risk premiums for providing fresh credit to the state that effectively priced the country out of the market. At the same time, the sovereign-bank doom loop increased the capital needs of the country. The Greek government and administration were ill-prepared to handle a crisis of such a scale and urgently needed financial as well as technical assistance to escape their predicament. The Greek problem was far beyond short-term assistance. A famous example is the lack of a cadastral plan which prevented the implementation of real estate taxes.

Many markets in Greece were over-regulated as well as dysfunctional and in urgent need of reform. A task that was too complicated to be handled by the Greek competition authority, which was under-staffed and under-financed. Today we know from the latest evaluations[14] that even a decade is not

13 Directorate-General for Economic and Financial Affairs (2010), The Economic Adjustment Programme for Greece. Occasional Papers 61, European Commission.

14 European Commission (2020), Enhanced Surveilance Report Greece. Institutional Paper 127, European Commission, Directorate-General for Economic and Financial Affairs.

sufficient to overhaul a dysfunctional public administration and create well-functioning new government agencies from scratch.

Given the size of the tasks, it was clear that the Greek state, which at the same time needed to cut spending and increase government revenues to reduce the government deficit, faced a steep uphill battle. Most importantly, Greece needed to rebuild trust of both the public and financial markets. In the negotiations with the Troika, Greece was in a weak position and not able to provide a sound and credible concept to resolve the crisis on its own.

The situation in Ireland was different. The country was a paragon of virtue when it came to formal adherence to the original SGP, see Figs. 1, 2. In the decade before the crisis, Ireland outperformed the SGP targets on a regular basis. The country experienced a prolonged boom. Throughout the 1990s, economic growth was mainly driven by export demand until domestic demand became the major driver of aggregate demand shortly after the start of the euro in 2002. There is no empirical or theoretical work done in this area that we are aware of. But it does not seem far-fetched to attribute the switch of the main driver for the Irish boom from export to domestic demand, at least partly, to the decrease in real interest rates after joining the common currency. Irish households used their increasing income and favorable credit conditions to invest in real estate which caused a housing boom and shifted the structure of the Irish economy towards the non-tradable sector. Non-traded sectors, government services and construction-related jobs, outperformed the traded sector in terms of wage growth. Thus, wages in the tradable sector grew faster than productivity and with that increasing Ireland's unit labor costs, while decreasing the competitiveness of its exports.

This development was reflected by the Irish tax system that was highly cyclical and heavily reliant on stamp taxes. Thus, Irish tax revenue was dependent on a continuous real estate boom.[15] Excess government revenue was used to decrease tax rates. The original SGP did not provide for a mechanism which allowed monitoring such behavior as it did not lead to

15 Directorate-General for Economic and Financial Affairs (2011), The Economic Adjustment Programme for Ireland. Occasional Papers 76, European Commission.

deficits or increased debt. In retrospect, fiscal policy in Ireland might have contributed to the overheating of the Irish economy. The housing boom was mostly financed by domestic banks which in turn relied on external borrowing. Thus, external debt increases were driven by private demand for credit. Here, we have an important difference to the case of Greece.

The real estate market crashed in 2007, at the time Ireland's debt-to-gross domestic product ratio was well below 25 %. The need to counteract the Great Recession together with the impact of the sovereign-bank doom loop drove government debt up to 95 % in 2011. Ireland was no longer able to withstand the pressure. It is worth emphasizing that the country had entered the crisis with an amount of fiscal space far exceeding that which had been deemed sufficient by the original SGP. Thus, it is reasonable to assume that even if the SGP had been obeyed to the letter by all member states, it would not have prevented the euro crisis. Fiscal policy simply is not up to the task of backstopping the national financial system. Only the central bank can fill that role as it is able to affect prices of financial markets because of its ability to create base money.[16]

Until 2010, Ireland had already implemented five consolidation packages. But the pressure, in particular the increasing costs for bank rescue packages proved too much to handle. The following package, the National Recovery Plan (NRP), failed to find the necessary majority support by the Irish parliament.

Ireland needed outside assistance and approached the Troika. The country did so with a good track record and a considerable cash reserve of Euro 17.5 bn. Ireland had already implemented measures that improved its competitiveness, cut public wages which spilled over to the private sector which saw decreased wages and unit labor costs improving competitiveness. The government also provided the NRP which served as a blueprint for the EAP.[17] Equipped with strengthened bargaining power and the opposition

16 Wyplosz, C. (2014), The Eurozone crisis: A near-perfect case of mismanagement. Economia Marche/Journal of Applied Economics, 0(1):1-13.

17 European Commission (2015), Ex post evaluation of the Economic Adjustment Programme Ireland, 2010-2013. Institutional Paper 004, European Commission Directorate-General for Economic and Financial Affairs.

parties at its side providing evidence for a high degree of national ownership, Ireland convinced the Troika of its ability to cope with the crisis on its own terms.

Somewhere between the two cases we have Portugal. The decade before the euro crisis was characterized by low productivity and low economic growth. Portugal's main problem was the inherited economic structure that was heavily reliant on low-skilled labor to produce export goods.[18] Because of lower wage levels and thus higher price competitiveness in South East Asia and Eastern Europe, Portugal lost export market shares. The country can be characterized as a case of structural change. A key problem in facilitating Portugal's economic structure towards more sophisticated goods was a lack of high-skilled labor. The national training system was not able to educate sufficient numbers of students.

As the SGP measured debt and deficits in ratios to the gross domestic product, Portugal was always walking a thin line. Public debt grew faster than the economy and the resulting slow growth of tax revenues made it challenging to finance the transformation of the economy. The government tried to bridge the gap by using public-private partnerships (PPP) and relied on state-owned enterprises (SOE) to support the anemic labor market. As a result, inefficient markets dominated by SOEs such as, the energy or transportation market pushed the Portuguese economic structure towards the non-tradable sector and led to wage increases at the same time.[19] Even

18 Blanchard, O. (2007), Adjustment within the euro. The difficult case of Portugal. Portuguese Economic Journal, 6(1):1-21; Directorate-General for Economic and Financial Affairs (2011), The Economic Adjustment Programme for Portugal. Occasional Papers 79, European Commission; Blanchard, O. and Portugal, P. (2017), Boom, Slump, Sudden stops, Recovery, and Policy Options. Portugal and the Euro. GEE Papers 0072, Gabinete de Estrategia e Estudos, Ministerio da Economia.

19 Such problems are well known and documented e.g. for Germany. The cases of the Saarland and Bremen in the 1980s and 1990s that were bailed out by the German government are similar. Seitz, H. (1999), Subnational government bailouts in Germany. ZEI Working Papers B 20-1999, University of Bonn, ZEI - Center for European Integration Studies.

without the euro crisis, Portugal would have had to act on these problems eventually.[20]

The increase in external borrowing was driven by the private and public sector alike, government investment and private consumption financed by a credit boom. In 2010, a revision of the European statistical system led to debt accumulated by SOEs and PPPs being accounted as government debt. This change in accounting increased the debt-to-gross domestic product ratio by roughly 10%, see Fig. 2.

Portugal’s public finances were already under stress because of the Great Recession. Warned by the Greek example, Portugal saw a flight to safety by foreign investors in its public debt and banking system, i.e. contagion. The government tried to ease the pressure by consolidation measures, a new consolidation Package, the “Portugal 2020 - Programa Nacional de Reformas” was suggested in 2010. At its core, it was an attempt to dampen public spending and promote an internal devaluation by cutting public wages, which through spillovers should decrease private wages. As a result, unit labor cost should decrease along with an increase of Portuguese competitiveness as compared to its main trading partners inside and outside the euro area. The negotiations with social partners to preserve social peace where well under way but the “Stability Program” failed to gain approval by legislators in March 2010. The following interest rate increases on Portuguese public debt effectively priced the state out of financial markets. With no access to any other form of finance available, the Portuguese government sought help from the Troika.

Similar to the case of Ireland, negotiations were between the Troika, the Portuguese government as well as the opposition parties in view of increasing national ownership. The “Portugal 2020 Program” served as the blueprint for Portugal’s EAP.[21]

20 Blanchard, O. (2007), Adjustment within the euro. The difficult case of Portugal. Portuguese Economic Journal, 6(1):1-21.

21 Directorate-General for Economic and Financial Affairs (2011), The Economic Adjustment Programme for Portugal. Occasional Papers 79, European Commission.

The Economic Adjustment Programs

The programs for Greece, Ireland and Portugal were negotiated between the respective countries and the Troika.[22] The financing envelopes for Greece, Ireland and Portugal were Euro 110 bn, Euro 85 bn and Euro 78 bn respectively. The first program for Greece was focused on conditionality for the disbursement of the agreed upon financing envelope.

The later EPAs for Ireland and Portugal provided a detailed diagnosis of the economic situation and the rationales for the suggested policies. Their program description went into great detail with regard to the proposed reforms which were centered around the same core objectives:

- Restore the sustainability of public finances
- Restore the stability of the national financial sector
- Shift the economic structure towards the production of tradable goods
- Enact structural reforms of the goods and labor markets
- Privatize public assets
- Mitigate the negative social impact of the reforms.

At first sight, it seems surprising that cases as heterogeneous as the three countries were prescribed the same objectives. The devil is in the details, the objectives did not have the same impact on the design of the programs.

One example is the Irish EAP which lists only two suggestions for structural reforms, namely the areas of protected professions and fiscal governance. In contrast, the first program for Greece suggests roughly a dozen such reforms. Furthermore for Greece, the progress was meticulously tracked in subsequent evaluations and progress reports. But, according to the ex post evaluation for Ireland, it was never expected from Ireland that structural reforms would be a priority. The same can be said for privatization measures

22 Directorate-General for Economic and Financial Affairs (2010), The Economic Adjustment Programme for Greece. Occasional Papers 61, European Commission; Directorate-General for Economic and Financial Affairs (2011), The Economic Adjustment Programme for Ireland. Occasional Papers 76, European Commission; Directorate-General for Economic and Financial Affairs (2011), The Economic Adjustment Programme for Portugal. Occasional Papers 79, European Commission.

in Ireland as compared to Greece and Portugal.[23] Ireland did not sell public assets as market prices were disappointing. However, it should be recalled that cash inflows from privatizations were never calculated into the financing envelope for Ireland.

For Greece and Portugal, such revenues were added to the program envelope to increase program credibility. The ex post evaluations reveal that such practices stem from the need to reverse engineer financial needs with regard to adjusting them to the financial resources available for each program. To avoid such problems in the future the euro area introduced the European Stability Mechanism (ESM). It came into effect on 8 October 2012 and was endowed with 500 bn euro to provide financial assistance to its member states. But similar to Ireland's experience, it turned out to be exceedingly difficult to realize the anticipated revenues from privatization. Greece was still setting up appropriate administrative structures when leaving its third EAP in 2018.[24] Portugal had access to financial markets earlier than expected and was able to bridge financing gaps, a measure that eased the pressure to privatize considerably. In the end, additional money from privatization was not required.

All programs included reforms of fiscal governance. These were mostly overtaken by the course of events. The euro area response to the crisis in 2011-2012 included an overhaul of the SGP and with it the Fiscal Compact. The Fiscal Compact introduced the reformed SGP, which required implementation into national law, in order for member states to participate.[25] Moreover, all countries supplemented euro area-wide reforms by adjusting their budgeting systems and the introduction of independent fiscal advisory bodies. Greece stood as an exception, as the program conditionality

23 European Commission (2015), Ex post evaluation of the economic adjustment programme Ireland, 2010-2013. Institutional Paper 004, European Commission Directorate-General for Economic and Financial Affairs.

24 European Commission (2020), Enhanced Surveilance Report Greece. Institutional Paper 127, European Commission Directorate-General for Economic and Financial Affairs.

25 Bierbrauer, C. (2020), The Juncker Commission's contribution to the completion of the European Economic and Monetary Union: An early appraisal. IEER Working Papers 117, Institute of Empirical Economic Research, Osnabrück University.

demanded the creation of new government agencies as well as to restore the functionality of public revenue and tax administration by generally removing inefficiencies and fighting corruption.

The primary objective of each program was the restoration of fiscal sustainability. The IMF had ample experience in developing strategies to achieve this goal. An archetypical IMF program contains debt relief measures, currency devaluations and structural reforms. The underlying strategy is to ease the pressure immediately by decreasing the stock of debt and, at the same time, improve a country's price competitiveness on export markets to help boosting economic activity. The reforms then aim at ensuring long run sustainability of fiscal policy by removing structural weaknesses.[26]

The original EAPs did not contain meaningful debt relief measures. The reasoning behind the waiving of this option at the time was to avoid contagion and negative spillovers on other euro area members as was the case for Portugal.[27]

The membership in the euro area eliminates the possibility for exchange rate devaluations.[28] Moreover, the sovereign-bank doom loop, a result of the euro area architecture, increased the financing needs of all countries. Thus, the usual instruments to reduce the pressure to adjust spending and increase revenue were not available. The consolidation efforts had to be implemented by budgetary measures and were very ambitious amounting to more than 10% of the expected GDP over three years, in case of Greece roughly 13%. These numbers have to be interpreted with more than a grain of salt. At the time, the calculations were based on predictions. Some of these predictions were overoptimistic and others based on inaccurate statistical data. Our own

26 International Monetary Fund (2015), Crisis Program Review, IMF Policy Paper.

27 Ardagna, S. and Caselli, F. (2012), The Political Economy of the Greek Debt Crisis: A Tale of Two Bailouts. CEP Special Papers 25, Centre for Economic Performance, LSE.

28 It can be argued that devaluations are ineffective. They increase price competitiveness of exports but make imports more expensive at the same time. Both effects might offset each other if a country is reliant on imports for the production of its export goods, e.g. energy or commodities. See Alcidi, C. and Gros, D. (2015), The Greek economy is unlikely to benefit from further devaluation. CEPS Papers 10773, Centre for European Policy Studies.

calculations are representing an ex post perspective. Thus, the percentages naturally vary across different publications and should be interpreted as orders of magnitude rather than being precise to the decimal place.

The negotiated consolidation efforts were even more ambitious than suggested by the percentages. The original EAPs did not include debt relief measures. The programs foresaw the reduction of accumulated government debt to the permissive 60%-level by a sequence of primary surpluses and strong economic growth in the future. The SGP thresholds are calculated as ratios to the gross domestic product which implies that primary surpluses reduce the nominator, while economic growth pushes the denominator. However, empirical research finds that multi-year episodes of primary surpluses above 3% are exceedingly rare. The reduction of debt to the desired level of 60% would need a decade-long primary surplus in the ballpark of 5%. In case of Greece, the desired surpluses should have been above 7%. In all cases, it was assumed that no other economic crises would occur before the debt reduction was completed.[29] Such a sequence of substantial primary surpluses would require exceptionally favorable circumstances.

We recall that all EAPs were focused on spending cuts and revenue increases in view of restoring fiscal sustainability in the short run. The programs suggested that two thirds of the austerity measures would consist of spending cuts, the remaining third would stem from revenue measures. Recognizing that an avalanche of reforms would stretch the legislative and administrative capacity of the program countries, budgetary measures were marked for front-loaded implementation. This approach mirrors the scientific literature that suggests such an approach is the most effective. The reasoning behind is based on empirical research which finds that front-loaded implementation reduces uncertainty regarding the true extent and actual content of announced austerity measures which helps private agents to adjust to the policy change.[30]

29 Eichengreen, B. and Panizza, U. (2016), A surplus of ambition: can Europe rely on large primary surpluses to solve its debt problem? Economic Policy, 31(85):5-49.

30 Alesina, A., Favero, C., and Giavazzi, F. (2019), Austerity: When It Works and When It Doesn`t, Princeton University Press.

Additional reasoning laid out in the EAPs as well as in ex post evaluations is more based on the notion that governments have only limited political capital. If the reform process is stretched over a prolonged period, reform fatigue might set in, even halting it completely.

The overall composition of the suggested austerity measures is questionable. The emphasis was on spending cuts over revenue increases which is in line with the suggestions of the empirical literature on the topic. Although an exclusive focus on spending cuts would have been ideal, such a strategy would have required significantly higher financial assistance to the program countries. In relative terms, public investment was cut more severely than public consumption, which adversely affects the future growth perspective of the economy. In their statements on the ex post evaluations Ireland and Portugal made that precise point and criticized the program conditionality with regard to cuts in public investment. In particular, the Portuguese government was unhappy as it saw Portugal in need of public investment to facilitate structural change and did not believe that public investment had been inappropriately high in the past.[31]

Because of the distortionary effects of taxes, revenue increases are found to be less effective than spending cuts. Moreover, they decrease economic activity which in turn makes them less effective as they reduce the tax base.[32]

Ireland and Portugal had already implemented or at least prepared the lion’s share of austerity measures when entering their EAPs. Moreover, they demonstrated a high degree of national ownership, after all, they had provided the blueprints themselves. The case of Ireland is special nonetheless as the structure of the Irish tax system was part of the problem.

31 Paredes, J., Pedregal, D. J., and Perez, J. J. (2014), Fiscal policy analysis in the euro area: Expanding the toolkit. Journal of Policy Modeling, 36(5):800-823; European Commission (2015), Ex post evaluation of the economic adjustment Programme Ireland, 2010-2013. Institutional Paper 004, European Commission Directorate-General for Economic and Financial Affairs; European Commission (2015), Ex post evaluation of the economic adjustment Programme Portugal, 2011-2014. Institutional Paper 040, European Commission Directorate-General for Economic and Financial Affairs.

32 Alesina, A., Favero, C., and Giavazzi, F. (2019), Austerity: When It Works and When It Doesn`t. Princeton University Press.

Ireland's tax revenue was highly cyclical and reliant on the real estate market. Thus, re-adjusting the revenue structure by shifting it towards less cyclical forms of taxation, such as income tax, was the priority. The adjustment was implemented in a progressive way, i.e. higher income groups were more heavily taxed and the most vulnerable income groups mostly spared. The same approach was taken by the Irish and Portuguese government in other areas such as wage and pension cuts in the public sector.

Greece was the only country that was heavily reliant on technical assistance when formulating the austerity measures. The actual policy changes were similar to those in the other countries, but of a higher magnitude. Cuts to pension payments and public wages were more severe and the number of markets that needed reform was higher, affecting more households and firms if measured as a share of the respective populations. Both might have contributed to the low degree of national ownership in Greece leading to political turmoil and several changes of governments[33] under the consecutive programs.

The austerity measures served as a vehicle to achieve other objectives apart from just improving fiscal sustainability. As the possibility for exchange rate devaluations did not exist, the program countries needed to improve the competitiveness of their export sectors. Generally, the available alternatives are to improve price competitiveness, which is the idea behind devaluations, or to shift the production structure towards more sophisticated goods where the price elasticity of demand is lower. Or in other words, goods that are less exposed to price competitiveness. Empirical research suggests that the latter strategy is more sustainable in the long run.[34]

The first strategy is very popular, but it can only be applied to countries with a national currency and flexible exchange rate. In such cases, nominal

33 Over the course of the first program four prime ministers served in Greece. The second program saw a major political crisis that led to the election of Alexis Tsipras as the new prime minister and thus a fifth change of government. The government led by Alexis Tsipras then tried to renegotiate the terms of the second EAP for Greece which caused major setbacks in Greece's economic recovery and induced fears of reversibility of the common currency.

34 Marin, D., Schymik, J., and Tscheke, J. (2015), Europe's exports superstar - it's the organisation! Working Papers 889, Bruegel.

devaluations can be achieved fast. Internal devaluations suggested in the EPA's try to achieve devaluations by production cost decreases instead of exchange rate devaluation.

In public discussions, one side-effect of joining the euro is often overlooked. The member states are all open economies connected by strong trade relations. At the same time, they trade with the rest of the world. If the euro appreciates this will decrease price competitiveness versus the rest of the world. Producers from abroad are in a position to export to the euro area and foreign markets at relatively lower prices. Rivals within the euro area are affected in the same way. The euro area exchange rate responds to the monetary policy of the ECB and aggregate developments in the euro area, but the impact of any member state is a function of its economic weight. Moreover, member states of the euro area are affected asymmetrically depending on their export composition. If a country exports goods that have low price elasticity, changes in the nominal exchange rate will not lead to strong demand changes by countries outside the currency area. The opposite is true for export goods with relatively high price elasticity.

The nominal appreciation in the run up to the euro crisis favored Germany as the country's basket of export goods consists mainly of goods with low price elasticities. Countries such as Greece and Portugal are at a disadvantage. Firstly, they produce and export goods with high price elasticities, secondly, they import goods such as energy for which price elasticity is low, as no national substitutes exist. Thus, they lost export market shares and at the same time could not reduce their imports to compensate for the revenue losses.[35] Proponents of internal devaluations within the euro area often abstract from this fact. This can be very misleading, as an internal devaluation vs. member states of the euro area does not necessarily imply improved price competitiveness vis-á-vis the rest of the world. If the euro appreciates at the same time as the internal devaluation

35 Chen, R., Milesi-Ferretti, G. M., and Tressel, T. (2013), External imbalances in the eurozone. Economic Policy, 28(73):101-142.

takes place, it will diminish the gains obtained at export markets outside the euro area.[36]

Decreases in production costs to achieve internal devaluations are often supported by a shift in the tax system. The typical approach is to decrease the tax rates on inputs in production such as labor income taxes and increase excise taxes such as the value added tax (VAT). The government should consider such shifts carefully. They tend to put low-income groups that pay relatively little income taxes while spending the lion's share of their income on consumption goods at a disadvantage. The reform agenda of former German Chancellor Gerhard Schröder after the turn of the millennium is often cited as a positive example for policies that lead to internal devaluations.[37] Wages and prices are generally more rigid than exchange rates. Legislative changes of the tax system usually can only be carried out over a longer period of time. The same holds for internal devaluations. They are a lot harder to achieve than nominal exchange rate devaluations and need more time to come into effect. Moreover, the fact that real wage decreases are often necessary to regain price competitiveness by internal devaluations increases political resistance to such measures.

The second strategy implies a change in a country's economic structure and sector composition, e.g. moving from coal mining to industrial production. Structural change is even harder to achieve than internal devaluation and even more time consuming, sometimes taking decades. Here, EAPs are less suited. Instead, the task should be addressed to the EU's structural funds.

In any case, internal devaluations combined with structural reforms solve the problem of regaining lost competitiveness over time and not in the rapid fashion of a nominal devaluation. Thus, internal devaluations do not improve the fiscal situation immediately. They might even cost the government time and revenue when negotiating with social partners.

36 Wyplosz, C. (2013), The Eurozone Crisis and the Competitiveness Legend. Asian Economic Papers, 12(3):63-81.

37 Dustmann, C., Fitzenberger, B., Schönberg, U., and Spitz-Oener, A. (2014), From Sick Man of Europe to Economic Superstar: Germany's Resurgent Economy. Journal of Economic Perspectives, 28(1):167-88.

Ireland had already achieved internal devaluation before entering its EAP and had improved its price competitiveness considerably. Thus, the program objective was superfluous. Ireland needed assistance because of the sovereign-bank doom loop spinning out of control. That is also made clear in the program itself where it is stated that the program's purpose is to provide Ireland with "*ample time*". Meaning, Ireland needed time to reform its tax system to make the revenue structure less cyclical and to stabilize the national banking sector.

Portugal still had to regain competitiveness in its export markets. The country Portugal had already negotiated wage and pension decreases with social partners before entering the EAP in the run up to the "Stability Program". Portugal was able to implement the pre-negotiated measures, which included increases in excise taxes, over the course of the program in agreement with social partners and opposition parties.

Greece needed to do the same, but did not have pre-negotiated wage and pension cuts at the national level. Instead, the government had agreed to them as part of its EAP in view of receiving financial assistance. This difference might go a long way explaining the difficulties and delays in implementation that are well documented in the progress reports for Greece.[38] In retrospect, it was a brave assumption that Greece would achieve such a feat without any preparation and at short notice. It is not surprising that for Greece a program period of three years was insufficient.

According to the ex post evaluations for Ireland and Portugal, structural reforms were focused on the labor market and not fully if at all implemented on the goods market. This is worrisome as reforms of goods markets are more effective when it comes to improving the tax base and future growth perspective of an economy.[39] The most likely explanation is that the sheer number of reforms and austerity measures exceeded the administrative and legislative capacity of all program countries. In the flurry of reforms

38 European Commission (2020), Enhanced Surveilance Report Greece. Institutional Paper 127, European Commission Directorate-General for Economic and Financial Affairs.

39 Alesina, A., Favero, C., and Giavazzi, F. (2019), Austerity: When It Works and When It Doesn`t, Princeton University Press.

governments were able push well-prepared measures through the legislative process but were not able to initiate new measures. Only Ireland had a chance to manage the process, but Greece and, to a lesser degree, Portugal were likely to fail despite their best efforts.

As this became obvious very soon, in October 2011, half a year after Portugal had called for help the European Council decided to provide additional support. Originally, financial assistance to program countries was provided to one third by the IMF and two thirds by European Institutions.[40] European loans came with a margin, e.g. the yield interest on loans to Greece was based on the three-month Euribor with an initial margin of 300 basis points, in fact similar to the conditions of IMF loans. On 11 October 2011, the European Council decided to provide loans to member states undergoing an EAP close to but not below net costs. At the same time, the loan maturities were extended which was equivalent to a modest debt relief measure.

The situation of the program countries, in particular with regard to their ability to tap financial markets to issue new public debt titles did not ease decisively until the ECB stepped in. All changed after 26 July 2012, the day when its then President Mario Draghi promised to do "*whatever it takes*" to preserve the common currency. The European debt crisis was brought to a halt. On 6 September 2012, the ECB introduced Outright Monetary Transactions (OMT). OMTs allow the ECB to intervene in secondary sovereign debt markets. The yields on public debt issued by EMU member states returned to rates that fostered trust in sustainability of their public finances. The ECB took the role of lender of last resort for the public sector.[41]

Ireland and Portugal were henceforth in a position to borrow in financial markets. In case of Ireland, it helped the country to repay the now more expensive IMF loans early. For Portugal, it meant that the country was able

40 The Situation was complicated by the fact that the EAPs, before the establishment of the ESM, were co-financed by different European counterparts of the IMF. For Greece, there was a Loan Facility Agreement between the euro area member states and Greece. Later, EAPs were first co-financed by the European Financial Stability Facility and then, since 8 October 2012, by the ESM.

41 Wyplosz, C. (2014), The Eurozone crisis: A near-perfect case of mismanagement. Economia Marche / Journal of Applied Economics, 0(1):1-13.

to stay within the otherwise insufficient financial envelope of its EAP and ultimately to conclude the program successfully. All these outcomes were decisively affected by the intervention of the ECB.

It is safe to conclude that the internal devaluations and structural reforms included in the EAPs were appropriate and suitable to restore fiscal sustainability in the long run. However, they worked too slow to resolve the euro crisis in the short time available to stabilize the common currency altogether. Most importantly, the program countries all suffered from the sovereign-bank doom loop which they could not address by employing national measures. They were hostage to the defective original architecture of the euro area.

To restore the stability of the national financial sectors and with it the financial system of the euro area, all program countries took measures to improve the equity ratio of private banks. These took the form of direct provision of capital as well as measures to support the reduction of non-performing loans in their balance sheets.

Obviously, excessive risk taking by private banks was the root cause of their crisis. Insufficient observance and the flaws of the original SGP had led to unsustainable levels of public debt in Greece and Portugal in the aftermath of the Great Recession. But the example of Ireland shows that even the formal observance of the original SGP was not sufficient to avoid a public debt crisis. The sovereign-bank doom loop made it extremely challenging, particularly expensive, to compensate for the losses of the banking system. Moreover, it was the general negligence in prudential supervision at the national level that had facilitated, if not enabled, the excessive risk taking by private banks. The latter phenomenon is usually referred to as banking nationalism.[42] The measures suggested in the EAPs were suitable to address the immediate emergency, but inappropriate to break the sovereign-bank doom loop as they only eased the symptoms of the disease.

Decisive action at European level was called for. Grounded in the institutional knowledge about the weak spots of the euro area, the European

42 Gerlach, S., Schulz, A., and Wolff, G. B. (2010), Banking and Sovereign Risk in the Euro Area. CEPR Discussion Papers 7833, C.E.P.R. Discussion Papers.

Commission had already analyzed and had a good understanding of the situation, including proposals to address the vulnerabilities of the euro area.[43] The consensus view of leading economists is that an incomplete and asymmetric original SGP, fragmented prudential supervision of the financial sector and the lack of a common safe asset were the crucial weak spots of the euro area.[44]

The Commission and member states have been engaged in an ongoing reform effort since then.[45] The current state of play is that the euro area aims to complete its original architecture with a Financial Union that includes a Banking Union and a Capital Markets Union. To date, both are still incomplete, but important parts, such as common supervision over the most important European banks by the ECB and a Single Resolution Mechanism to support failing banks are now in place. While that does not completely undo the sovereign-bank doom loop, it mitigates its consequences for fiscal sustainability of affected member states.

The key problem of a strong home bias in the balance sheets of European banks is still there. Discussions evolve around two alternatives to resolve the issue. Firstly, prudential supervision endowed with the power to force European banks to hold a diversified portfolio of euro area government debt as collateral for transactions with the ECB. Secondly, the European Union as a whole provides a common safe asset.[46] Both solutions find themselves

43 European Commission (2010), Enhancing economic policy coordination for stability, growth and jobs - tools for stronger EU economic governance. Technical Report COM(2010) 367; European Commission (2010), Reinforcing economic policy coordination. Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, COM (2010)(250).

44 Baldwin, R. and Giavazzi, F., editors (2015), The Eurozone Crisis: A Consensus View of the Causes and a Few Possible Solutions. VoxEU.org Book, London: Centre for Economic Policy Research.

45 Bierbrauer, C. (2020), The Juncker Commission's contribution to the completion of the European Economic and Monetary Union: An early appraisal. IEER Working Papers 117, Institute of Empirical Economic Research, Osnabrueck University. OSN, ZEI

46 Benassy-Quere, A., Brunnermeier, M., Enderlein, H., Farhi, E., Fratzscher, M., Fuest, C., Gourinchas, P.-O., Martin, P., Pisani-Ferry, J., Rey, H., Schnabel, I., Veron, N., di Mauro, B. W., and Zettelmeyer, J. (2018), Reconciling risk sharing

obviously outside the scope of the EAPs. Even if the programs did provide relief for the acute national banking crisis, they were never able nor appropriate to resolve the underlying causes.

The final objective, to mitigate the social impact of the EAPs, became more prominent over time. The first EAP, for Greece, was strongly focused on fiscal sustainability and reforms which were aimed at restoring the competitiveness of Greek exports. Elements that are related to its social impact were largely neglected. However, it is worth mentioning that achievements of universal healthcare for all Greek citizens as part of the program objectives was suited to improve the situation for the most vulnerable members of Greek society. The general emphasis on fighting corruption and tax evasion was also likely to benefit the lower end of the income distribution disproportionately.

Later programs were more vocal in that regard. This is not surprising as the programs for Ireland and Portugal were mostly following individual national suggestions, which in both cases, were already negotiated, between the governments and their social partners. Ireland's tax reform towards less cyclical sources of government revenue was strongly progressive, mostly sparing the lower income groups. The same is true for the country's reform of its social insurance systems and cuts to welfare payments. Obviously, lower income groups were nevertheless negatively affected by increases in excise taxes. Portugal followed the same strategy. Generally, the burden of the EAPs was more broadly shared by all social groups in these countries.

The aspects of maintaining the functioning of the social safety net and fair sharing of the burden of necessary reforms when undergoing an EAP gained more traction when a new Commission under Jean-Claude Juncker came into office on 1 November 2014. Juncker spelled out socially acceptable reform policies as one of the priorities of his Presidency.[47]

with market discipline: A constructive approach to euro area reform. CEPR Policy Insight 91, Center for Economic Policy Research.

47 Juncker, J.-C. (2014), A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change, European Commission.

At the time, Ireland and Portugal had already completed their programs. Generally, the perception of social injustice has the potential to undermine acceptance and national ownership of EAPs. As a result, legislative steps are likely to become more difficult leading to reform fatigue. A situation like that does not benefit the program objective of restoring the national ability to act without European assistance as soon as possible.

The Economic Fallout from the COVID-19 pandemic

The Covid-19 pandemic has brought economic life in Europe to an abrupt temporary halt in the first half of 2020. Although the lockdown that was enacted by individual member states of the European Union has been largely lifted by early summer, some restrictions have been kept in place. Particularly, retailers, tourism and gastronomy continue to be subject to hygiene regulations, perhaps cautious enough to keep new infections under control, but cumbersome enough to disturb their usual business model.

Economic forecasts are always subject to uncertainty. But the present situation makes them even more difficult. For Germany, the economic downturn is predicted to be the most severe since the end of Second World War. Latest figures estimate a decline in economic activity of 6.5%, for 2020. Nevertheless, the German Council of Economic Experts (SVR) expects a V-shaped recovery with the gross domestic product regaining its pre-crisis level in 2022.[48]

However, the predictions of the SVR assume that no further lockdown of economic activity will occur in Germany or in other EU member states. Their latest survey recognizes the downside risks because of the country's strong reliance on trade. Thus, a resurgence of the pandemic amongst Germany's main trading partners also puts the German recovery at risk. By the end of July 2020, the scenario allowed for cautious optimism. While the European development seems broadly in line with SVR predictions, they gravely underestimated the infection rates that the United States of America has

48 Sachverständigenrat (2020), Konjunkturprognose 2020 und 2021. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung Statistisches Bundesamt.

experienced. Keeping in mind that the United States is a very important trading partner for the EU, the expectations of the SVR might be too optimistic. For the euro area and the EU as a whole, the precarious circumstances caused by the COVID-19 pandemic make reliable predictions difficult. What we do know is that the CORONA pandemic has already increased public debt and deficits across the euro area. The average level of public debt in the euro area has already reached 86.3% measured as a share of national gross domestic products.[49] Fiscal support will be required to bolster economic activity. But the high levels of debt, in particular, in the member states that earlier received financial assistance from the EU make those most vulnerable. The approach stipulated by the EAPs, to reduce debt by primary surpluses, did not work fast enough to create sufficient fiscal space to respond to an economic crisis that followed too soon after the last. While Ireland, which has been still above the pre-euro crisis level, marks an exception neither Greece nor Portugal came close to being in a position to issue meaningful fiscal stimulus.

Thus, the original concept of the euro area that left fiscal decision and, with it, business cycle stabilization for the national level cannot be applied. Countries, such as Germany or the Netherlands, would be able to issue sizable fiscal stimulus packages while Greece, Portugal or Italy simply do not have the fiscal space to do so. Thus, the COVID-19 pandemic has the potential to destabilize the euro area as well as the EU as a whole.

There has been a growing public and political awareness of the problem. We write this paper at the end of July 2020, only days after the historic agreement on the *Recovery Plan for Europe* and the decision on the European budget for 2021-27 by the European Council on 21 July 2020.[50] The overall budget of the European Union for 2021-27 has a volume of 1 824.3 bn. The included COVID-19 recovery package to support all member states of the EU has a volume of Euro 750 bn of which Euro 390 bn are grants, meaning that the receiving countries will not have to repay this part of the financial assistance. Instead, it will be financed by contributions of member states. The remaining

49 Source: Eurostat

50 European Council (2020), European Council conclusions, 17-21 July 2020. Brussels, 21 July 2020, EUCO 10/20.

Euro 360 bn will be provided to member states as credit lines that have to be settled in the future. The recovery package will be pre-financed by the common issuance of public debt by the Union.

The *Recovery Plan for Europe* is nothing less than a watershed moment in the history of the EU as it marks the first time that the European Commission has been authorized to act in the fashion of a European Treasury for a well-defined purpose. Common bonds will be issued that are guaranteed by the member states of the EU and that will be repaid by the Union. It was also agreed that the EU will have its own sources of revenue in the future although the precise sources are not specified yet. Although many details were left for further negotiations, the agreement on the *Recovery Plan for Europe* is a step towards deeper European integration that seemed out of reach when Jean-Claude Juncker left office as the President of the European Commission less than a year ago on 31 October 2019.[51] He failed with similar proposals regarding the creation of a common safe asset time and again.

As the European Parliament, as well as the national legislators of all member states, still have to ratify the *Recovery Plan for Europe*, it appears too early to discuss its details. Provided that ratification procedures are swiftly done and member governments come forward with meaningful project proposals, the measures agreed upon and steps already taken should be appropriate to make developments similar to those that we experienced around the euro crisis a decade ago less likely.

There will be an undesired side-effect: The necessary urgent response at EU level to the health-crisis has shifted attention away from the ongoing reform efforts regarding completion of the euro area architecture. In particular, the Banking Union as part of the Financial Union is still missing critical elements. While the issuance of common bonds as part of the response to the COVID-19 pandemic will create a small quantity of a European safe asset, the European Deposit Insurance System is still not finalized and the prudential supervision of the ECB over the euro area banking system is still

51 Juncker, J.-C. (2019), "Europe: a matter of the heart". Speech to the European Parliament on the 22nd October 2019; Bierbrauer, C. (2020), A Deeper and Fairer Economic and Monetary Union. In Stüwe, R. and Panayotopoulos, T., editors, Politicizing EU Policies - the Juncker Commission 2014-2019. Nomos Verlag.

restricted to major banks. Small and medium-sized institutes remain under national oversight.

The Halle Institute for Economic Research (IWH)[52], in a recent survey about the German banking system, warns that bankruptcies as a result of the COVID-19 restrictions might put Germany's small and medium sized banks at risk. In particular, Germany's special savings and cooperative banks will be more exposed to the economic fallout because of their business model. These financial institutes are specialized in lending to small businesses. Thus, they are more exposed to sectors, such as services, retail trade and gastronomy that have been hit hardest by social distancing measures. A steep increase in bankruptcies amongst clients, mostly small and medium-sized enterprises, might follow. According to the IWH study, repercussions for the scores of also small and medium-sized financial institutes will be that many will require recapitalization. The likely resulting new banking crisis might add up to the same order of magnitude as the banking crisis that led to the euro crisis. However, there will be a difference. This time it will not be a crisis of a few major banks but scores of small ones. This is a very worrisome outlook, as the reform of the euro area architecture has left that part of the banking system under national supervision, so far. The risk of banking nationalism as in the run up to the euro crisis is still present.[53] Especially, as an emerging renewed banking crisis might remain undetected for some time. Even a small chance for such a worst-case scenario should lead to immediate action. In particular, as the risks feared for the German banking system are likely to plague other euro area members as well.

The pressure to recapitalize scores of small and medium sized banks breeds the risk of a re-ignition of the sovereign-bank doom loop, which together with the incomplete Financial Union would almost guarantee a resurgence of the euro crisis despite the undeniable progress achieved at the last European Council.

52 Reint E. Gropp, Michael Koetter, William McShane (2020),. The Corona Recession and Bank Stress in Germany. IWH Online 4/2020. Halle (Saale).
53 Gerlach, S., Schulz, A., and Wolff, G. B. (2010), Banking and Sovereign Risk in the Euro Area. CEPR Discussion Papers 7833, C.E.P.R. Discussion Papers.

Conclusions

We broadly evaluated the EAPs for Greece Portugal and Ireland and find that these were similar in their objectives but varied considerable in design details. All EAPs were too extensive and beyond the administrative and legislative capacity of the program countries. Ireland and Portugal followed common sense and used their strong bargaining positions to pick well-defined policy areas, focusing on these in implementation. Both countries were successful and did not need assistance exceeding that of the original programs. But the willingness of the ECB to intervene in financial markets strongly contributed to that outcome.

Greece was in a much weaker position. The country was required to firstly create the pre-conditions for successful implementation, namely a functioning administration. One three-year program was not sufficient. Greece needed three consecutive programs, or nine years, until it was able to finally leave the programs in 2018. Today, it is still engaged in an ongoing reform process. No country was able to meet all conditionalities under the first three EAPs, not even Greece, with nine years of time. One lesson to draw from this exercise is that future EAPs should be more focused as the micro-management approach has failed. In particular, a reduced number of more focused conditionalities would improve transparency and accountability.

The key objective of all EAPs was to restore the sustainability of public finances. In particular, current deficits and levels of public debt within the limits of the SGP. The favored approach was to use budgetary measures to keep the deficits not only within the permissible range but to maintain primary surpluses over a prolonged period of time. To achieve levels of public debt below the 60%-threshold of the SGP at least a decade of substantial surpluses combined with strong economic growth were needed. The key motivation behind such an approach was to avoid public defaults to minimize the danger of contagion. In hindsight, contagion could be avoided, mainly because of the support provided by the ECB.

The time available to implement this strategy proved to be far too long. Unfortunately, the COVID-19 pandemic hit the EU before sufficient

progress could be achieved. What we have learned is that all future programs either require the inclusion of debt relief measures right at the start or the provision of financial resources that allow for fiscal stabilization policies without increasing national debt in the period needed to return public debt to the target level. We see that the second route was taken by the European Council on 21 July 2020. This decision implies that the EU is turning away from the original concept of leaving business cycle stabilization to national governments. At least, for the measures related to fighting the economic fallout caused by the COVID-19 pandemic.

Coming back to the earlier EU programs, we can see that they were accompanied by major reforms of the euro area architecture but vulnerabilities of the common currency remain. The Financial Union is still not completed and the prudential supervision of the banking sector remains fragmented. The ECB oversees the major European banks while small and medium sized institutes are under national supervision. A recent study of the IWH shows the dangers of such an approach. It leaves room for banking nationalism and breeds the danger of a future banking crisis as a result of unhealthy developments in the sector of small and medium sized banks. There looms the risk that such developments might be detected too late.

In 2020, we face a situation comparable to that of the Great Recession in many respects and European banking systems are still on shaky ground. The Corona pandemic implies an economic shock of at least the same magnitude and most euro area countries are in a fiscal position that is even weaker than in 2007.

The historic agreement on the *Recovery Plan for Europe* and the European budget for 2021-27 reached by the European Council on 21 July 2020 will be a major step in the right direction. However, should European leaders – along with the implementation of the recovery plan and respective measures foreseen by the multi-annual budget - not act swiftly towards completion of the euro area architecture, which removes the remaining weak spots; they will miss out on their leverage to avoid the resurgence of another euro crisis.

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