Agnès Benassy makes four main points

1. Crisis not just due to poor fiscal policy but also due to private sector (banks)
   - Implication: SGP type rules are insufficient; bank regulation supervision must be improved

2. Direct exposure of (Northern) €Z to (Southern) periphery is very large, both direct and indirect
   - Implication: ?

3. Institutional/constitutional failure (Treaty)
   - Implication: need of macro (€Z) strategy and default clause

4. Eurobonds may be an attractive solution, but imply further political/fiscal integration. Do we (citizens) want it and can we do it with all €Z members?
   - Implication: ?
(1) The role of private (mis)behavior: a Balance of Payments perspective

- The table below shows that up till 2007 average public sector finances in the South (GR, PT, ES, IE) was not dramatic (though not complying with SGP)
- The private savings gap (mainly through banks) on the other hand became excessive: misbehavior or not?
- Result: build-up of large foreign (public+private) debt position in South

<table>
<thead>
<tr>
<th>Current Account vs Public and Private Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Account</td>
</tr>
<tr>
<td>South           -0.7  -6.8</td>
</tr>
<tr>
<td>North           0.9   4.6</td>
</tr>
</tbody>
</table>
Foreign debt dynamics

- In the period 1999-2007 two-thirds of gross foreign borrowing by South was used to pay the interest on the foreign debt: a vicious circle!

<table>
<thead>
<tr>
<th>Current Account Decomposition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Account</td>
</tr>
<tr>
<td>South</td>
</tr>
<tr>
<td>North</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>
(1) Conclusion

- We have seen that banking risk can quickly become sovereign risk and sovereign risk can easily become banking risk.
- I agree with Agnès that the simple SGP rules (even when strengthened) are insufficient to cope with this.
  - The attempt to include implicit (bank default) guarantees into fiscal rules is a step in the right direction (though I have some questions on the implementation).
  - In addition, cumulative current account imbalances should be taken much more seriously as an indicator of potential crisis [Note that the crisis so far has not reduced CA imbalances: public (TARGET) flows have taken over from private capital flows].
- Pooling of banking risk is in the same league as the creation of eurobonds, preempting further political/fiscal integration.
(2) High €Z exposure to countries in (near) default

- I agree: the obvious conclusion is that this is going to cost the stronger €Z countries much more than we are willing to admit in public, regardless of the path we choose.

- Bearing (some of) the pain directly now by letting Greece default, probably provides better conditions for the future.

- In addition:
  - Collapse of the €Z implies very considerable wealth redistribution, changes in competitiveness and other transition costs.
  - Supporting the €Z implies long term transfers (in return for economic control) to weaker countries.
  - Overall, my guess is that the latter is to be preferred to the former (if voluntarily agreed upon).
(3) Institutional/constitutional failure

- True; incentive compatibility constraints work better in theoretical models than in reality
- Sovereign default should be possible (and would even now be a good solution for Greece for example)
- Ex post penalties on inappropriate fiscal policies are quite unlikely to work, ex ante (independent) approval of national fiscal policies is to be preferred (also preferred to constitutionally embedded fiscal rules)
  - If so, eurobonds could be an element in a new set-up
- I sincerely doubt an additional €Z macroeconomic strategy (stabilization) policy (by a euro government) is desirable or feasible
- What is missing is how to realize the necessary economic convergence (productivity, competitiveness); so far: no convergence despite all capital flows from N to S
Relative total factor productivity (average = 100), 1992-2007
(4) Further integration

- To maintain the common currency, some further political (fiscal) integration is a necessary condition.
  - For this to happen, broad public support appears necessary; currently such support is absent.
  - To gain such support, a positive message is needed.
  - How far the integration needs to go (pooling of banking risk, eurobonds, …., euro government) is to be seen.
- To have countries leave the €Z to promote further integration among the others appears a very risky strategy as contagion risks and speculative attacks will rise and the credibility of the €Z itself will fall.