Zeszyty Naukowe
Wyższej Szkoły Bankowej w Poznaniu
2013, t. 48, nr 3

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Euroland's Crisis. Selected Problems and Solutions

Abstract. *This paper deals with issues critical to the European Monetary Union along two lines: the banking (financial) crisis aspect and the debt crisis aspect. In particular, it focuses on the difficulties observed in the PIIGS countries. While analyzing the position and actions of the European Central Bank (ECB), the author emphasizes its monetary policy decisions and non-standard operations alongside their impact on commercial banks and the real economy. An interesting question is raised about the independence of the ECB. Subsequently, the paper discusses some proposed solutions to the most recent crisis as well as preventive measures addressing future challenges, specifically such financial instruments as the EFSF, the ESM or, last but not least, the Fiscal Compact, regarded as the first step to a political union.*

Keywords: *crisis, monetary policy, debt, Euro area*

1. Introduction

In recent years, the term "crisis" has been a much discussed topic. Definitions of crisis can be found in the works of such authors as Mishkin[1] or Goldsmith,[2] whereas models explaining the origin of crises were proposed by Krugman.[3]

[1] F.S. Mishkin, *Understanding Financial Crises: A Developing Country Perspective*, "NBER Working Paper" 1996, No. 5600.

[2] R. Goldsmith, *A Comment on Minsky's Financial Instability Hypothesis*, in: *Financial Crises. History, Theory and Policy*, ed. C. Kindleberger, J.-P. Laffargue, Cambridge University Press, Cambridge 1982, pp. 98-102.

[3] P. Krugman, *A Model of Balance-of-Payments Crises*, "Journal of Money, Credit and Banking" 1979, Vol. 11, No. 3, pp. 311-325.

Krugman's model was further developed by authors like Roubini,[4] Garber,[5] Obstfeld,[6] or Eichengreen and Bordo.[7] The crisis in Europe has changed its nature from a banking sector crisis, to a liquidity crisis, to an economic crisis and sovereign debt crisis. The paper deals with the impact of the financial and economic crisis on the European banking system, placing emphasis on the ECB monetary policy and the recent euro area crisis. The final part of the paper describes some of the solutions that address the causes and effects of the ongoing crisis.

2. The financial crisis and its impact on the European banking sector

This part of the paper describes the ECB's position and monetary policy measures undertaken in response to the crisis impacts, and also deals with the impact on the European banking sector.

2.1. The ECB monetary policy in normal times and its impact on real economy

The recent global (financial and economic) crisis has called for unprecedented policies by monetary authorities worldwide. Over the past crisis years, the ECB monetary policy has also had to face new challenges.

In general, the primary objective of the ECB's monetary policy is to maintain price stability. The ECB aims at inflation rates close to 2% over the medium term. Monetary policy affects prices and the economy broadly through several channels. Simply speaking, changes in the central bank's key policy interest rate affects rates relevant to households and firms, including bank lending rates and deposit rates, and therefore, consumption, saving and investment decisions. These decisions influence aggregate demand and, ultimately, price-setting behavior as well as the formation of inflation expectations. In the euro area this channel, usually referred to as the interest rate channel, has been found to have the most influence on the economy. The functioning of the money market is critical to this transmission mechanism of monetary policy. In standard times, the ECB influences money market interest rates by setting its key interest rates and by managing the liquidity situation in the euro area money market.

[4] N. Roubini, *Crisis economics. A Crash Course in the Future of Finance*, Penguin Press 2010.

[5] P.M. Garber, *The TARGET mechanism: will it propagate or stifle a Stage III crisis?*, "Carnegie-Rochester Conference Series on Public Policy" 1999, Vol. 51, No. 1, pp. 195-220.

[6] M. Obstfeld, *The Logic of Currency Crises*, "NBER Working Paper" 1994, No. 4640.

[7] B. Eichengreen, M.D. Bordo, *Crises Now and Then: What Lessons from the Last Era of Financial Globalization*, "NBER Working Paper" 2002, No. 8716.

In standard times, the operational framework of the ECB monetary policy comprises the following three sets of instruments: open market operations (OMO), standing facilities, and minimum reserve requirements for credit institutions.

Table 1. Standard instruments of ECB monetary policy

Open market operations	Open market operations (OMO) play an important role in steering interest rates, managing the liquidity situation in the market and signaling the monetary policy stance. There are four types of OMO: – main refinancing operations (MRO) – regular liquidity-providing reverse transactions with a frequency and maturity of one week; executed by national central banks (NCBs) on the basis of standard tenders, – longer-term refinancing operations (LTRO) – liquidity-providing reverse transaction that are regularly conducted with a monthly frequency and a maturity of three months (6, 12, 36 months are also possible), – fine-tuning operations – which can be executed on an ad hoc basis to manage the liquidity situation in the market and to steer interest rates, – structural operations – which can be carried out through reverse transactions, outright transactions and issuance of debt certificates; these operations will be executed whenever the ECB wishes to adjust the structural position of the Eurosystem vis-à-vis the financial sector (on a regular or non-regular basis).
Standing facilities	Standing facilities aim to provide and absorb overnight liquidity, signal the general monetary policy stance and bound overnight market interest rates. Two standing facilities, which are administered in a decentralized manner by national central banks, are available to eligible counterparties on their own initiative: – marginal lending facility – counterparties can use the marginal lending facility to obtain overnight liquidity from the NCBs against eligible assets, – deposit facility – counterparties can use the deposit facility to make overnight deposits with the NCBs.
Minimum reserves	The intent of the minimum reserve system is to pursue the aims of stabilizing money market interest rates, creating (or enlarging) a structural liquidity shortage and possibly contributing to the control of monetary expansion.

Source: www.ecb.int [17.09.2012].

In standard times, the ECB directs money market interest rates using standard instruments of monetary policy, thus influencing the development of economic figures toward the intended outcomes. During a crisis, the ECB's monetary policy using standard instruments has had little or no impact on financial markets and the real economy. This led the ECB to implement a variety of "unconventional measures".

During the crisis period, the ECB used both standard and non-standard measures to adjust the provision of liquidity in the banking sector, and reduced its interest rates to the lowest levels historically. Changes in the key ECB interest rates are shown Fig. 1.

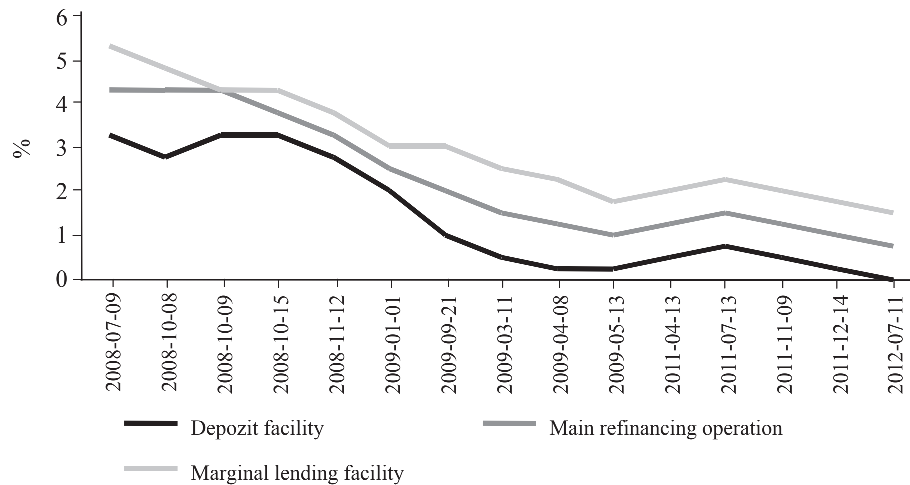

Fig. 1. Key ECB interest rates during the crisis

Source: www.ecb.int [17.09.2012].

Using the standard interest rate transmission channel of monetary policy, the ECB was not able to achieve its objectives in the real economy. This is clearly demonstrated by the macroeconomic indicators illustrated in the charts below.

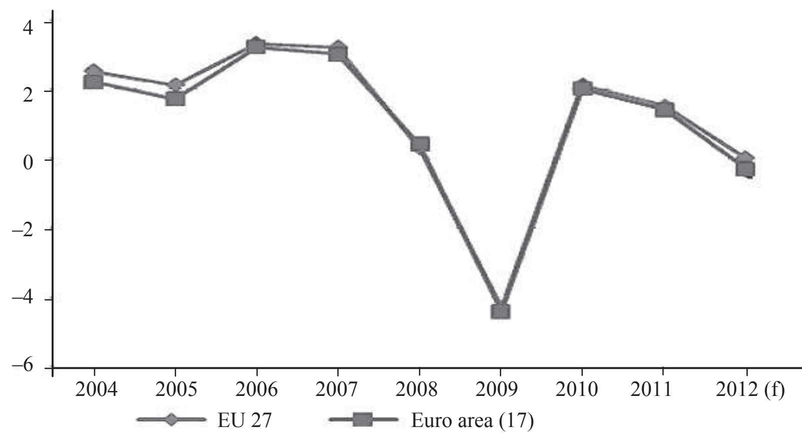

Fig. 2. The real GDP growth rate

Source: epp.eurostat.ec.europa.eu.

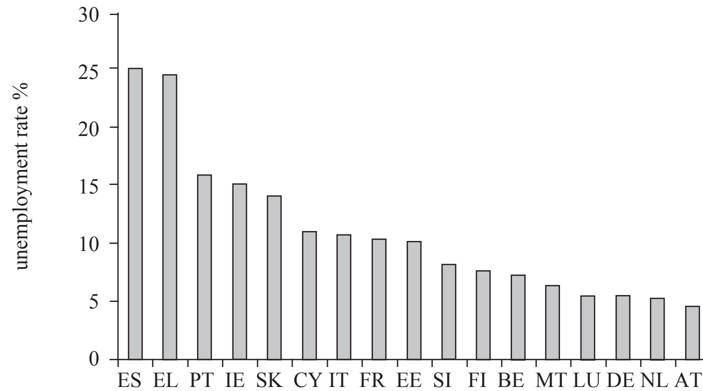

Fig. 3. Unemployment in the euro area in July 2012

Source: epp.eurostat.ec.europa.eu.

The crisis halted economic growth in most of the euro area countries. Arguably, the most negative impact of the crisis can be seen in the euro area unemployment rate, which rose to 11.3% in July 2012. The highest unemployment rate at 25.1%, was observed in Spain.

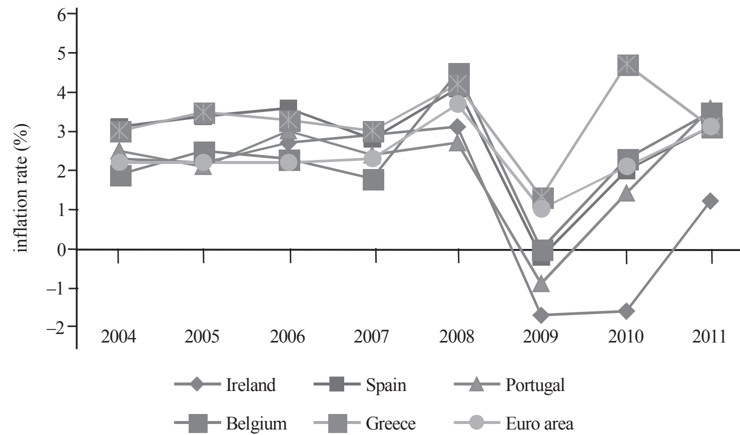

Fig. 4. The inflation rate (%)

Source: own, based on data available from epp.eurostat.ec.europa.eu.

Due to insufficient liquidity, deflation pressures occurred in 2009-2010 in countries such as Ireland, Spain, Portugal and Belgium. On the other hand, the highest 2010 inflation rate, that being 4.7%, was observed in Greece.

2.2. The position and monetary policy of the ECB in turbulent times

The ECB's monetary policy using standard measures clearly failed to achieve its objectives in the crisis period. The text below outlines the ECB's response to the financial crisis involving the use of non-standard measures.

According to J.M. González-Páramo, member of the ECB Executive Board, four phases can be distinguished in the European Central Bank's monetary policy during the financial crisis: Phase 1 – "The Market Turmoil Phase" (9 August 2007 through 15 September 2008); Phase 2 – "The Financial Crisis Phase" (the last quarter of 2008 through the first quarters of 2009); Phase 3 – "The Phasing-Out Phase" (December 2009 to April 2010); Phase 4 – "The Sovereign Debt Crisis Phase" (Spring 2010 until present).

The first phase – "The Market Turmoil Phase"

In August 2007, tensions related to the US subprime mortgages started to cause liquidity shortages in money markets around the world. A number of European banks disclosed their direct and indirect expositions to the subprime mortgages market. This resulted in growing distrust toward banks and problems with market liquidity. The ECB provided liquidity to ensure the correct functioning of the money market. Between August 9-12 2007, it injected €335 billion into the euro area banking system. In March 2008, the ECB introduced a six-month longer-term refinancing operation to support the normalization of the euro money market.

The second phase – "The Financial Crisis Phase"

This period was marked by a sharp contraction in global output and trade, followed by a sluggish recovery. During this period the ECB implemented "nonstandard" monetary policy measures, which were subsequently referred to as "enhanced credit support". The non-standard measures included the following elements:

– the "fixed rate full allotment" tender procedure in all refinancing operations ensuring the provision of unlimited central bank liquidity to eligible euro area financial institutions at the main refinancing rate and against adequate collateral. This measure was designed to support the short-term funding needs of banks, with a view to maintaining the availability of credit to households and companies at accessible rates;

– an extended list of assets accepted as eligible collateral for refinancing operations (the credit threshold for eligibility was lowered form A- to BB- for marketable assets and non-marketable assets);

– extending the list of counterparties eligible for fine-tuning operations;

– additional longer-term refinancing operations with a maturity of up to six months.

Furthermore, in July 2009, in an effort to support the financial market, the ECB launched the first Covered Bond Purchase Programme (CBPP), which was an important step for the longer-term funding of banks as well as for the financing of the real economy.

The third phase – "Phasing-Out Phase"

Between December 2009 and April 2010, the ECB initiated the gradual phasing out of the non-standard policy measures. For example, it did not renew the one-year longer-term refinancing operations and other supplementary refinancing operations with maturities of 3 and 6 months.

The fourth phase – "The Sovereign Debt Crisis Phase"

In early 2010, tensions re-emerged in some segments of the financial market, in particular in the euro area government bonds market. The divide between the ten-year government bonds of some euro area countries relative to the German bonds started to grow.

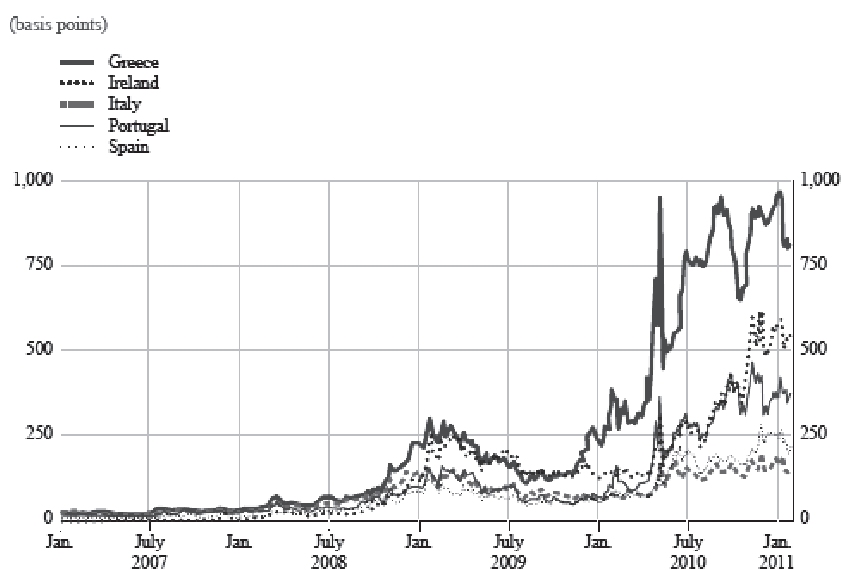

Fig. 5. Ten-year government bond spreads
for selected euro area countries vis-á-vis German bonds

Source: www.ecb.int [18.09.2012].

In May 2010, the ECB launched the Securities Market Programme (SMP). Under the program, the ECB and the euro area national central banks (NCBs) could intervene in the financial market, especially in the government bonds mar-

ket, to an extent permitted by the ECB Governing Council. The key feature of asset purchases made under the SMP was that their liquidity impact was sterilized through the conduct of weekly liquidity absorbing operations.

In reaction to strong tensions in the financial market which could lead to money market dysfunction and to the disruption in bank lending to households and firms, the ECB decided to implement two long-term refinancing operations with a 3-year maturity, known as the Covered Bond Purchase Programme 2 (CBPP 2). The rates in these three-year operations would be fixed at the then average rate of the MROs (at that time, it was at 1%).

On December 22 2011, the ECB provided 523 banks with 530 bn of liquidity, and on February 29 2012 it provided 523 banks with 489 bn of liquidity. The provision of longer-term liquidity was designed to avert tensions over lending, especially in the countries currently facing problems (PIIGS). As a result of the debt crisis, many commercial banks in the euro area are unable to obtain sufficient refinancing either via the interbank market or the capital market and are obliged to take up ECB refinancing.

Banks tend to reinvest a large proportion of additional liquidity with the ECB in the form of short-term deposits – in the meantime, short-term deposits at the ECB exceeded €800 bn. Banks, have thus, gained access to a cushion to ease future refinancing problems. The resulting increase in the ECB balance sheet during the crisis is shown in Fig. 6.

Fig. 6. The ECB balance sheet – all assets

Source: www.zerohedge.com [17.09.2012].

Fig. 7 illustrates the liquidity increase in the Eurosystem following the implementation of changes in the ECB operational framework. It should be noted that banks did not use this additional liquidity for interbank lending or for lending to households and businesses, but they reinvested it using the ECB's deposit facility.

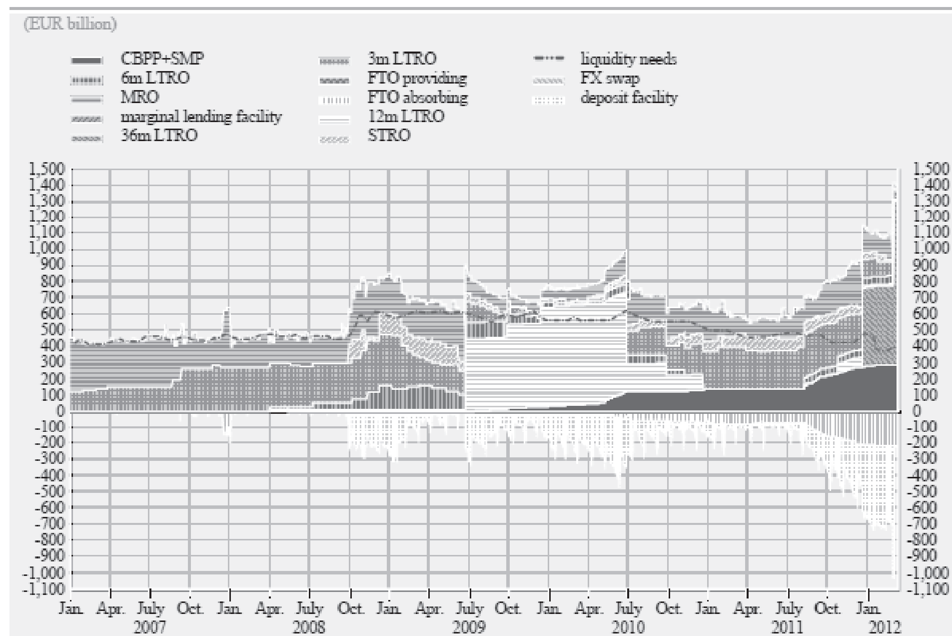

Fig. 7. Recourse to the ECB's market operations and standing facilities

Source: ECB [17.09.2012]

Besides burdening economic performance throughout the world, the global crisis – despite recourse to non-standard monetary policy instruments – transformed into a sovereign debt crisis.

3. Debt crisis in the Economic and Monetary Union

The financial and economic crisis in Europe has transformed into a debt crisis as a result of multiple factors. The sovereign debt crisis in the euro area is a symptom of policy failures and deficiencies in, among other things, fiscal policy coordination. The Maastricht Treaty and the Stability and Growth Pact laid down specific rules for public finance: public debt up to 60% of GDP and a fiscal deficit up to 3% of GDP. When the financial crisis hit, fiscal expansion and support for the financial sector meant that public finance deteriorated significan-

tly in the euro area. The average euro area (12) budget deficit reached 6% of GDP in 2010, and the average public debt reached 85% of GDP. Fiscal imbalances in the euro area as well as in the EU are shown in the following charts.

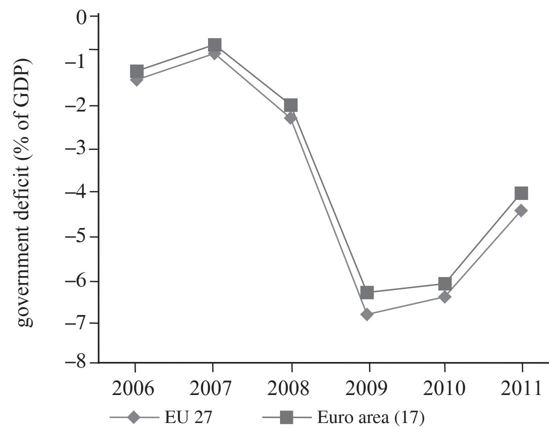

Fig. 8. Government deficit (% of GDP)

Source: epp.eurostat.ec.europa.eu [16.09.2012].

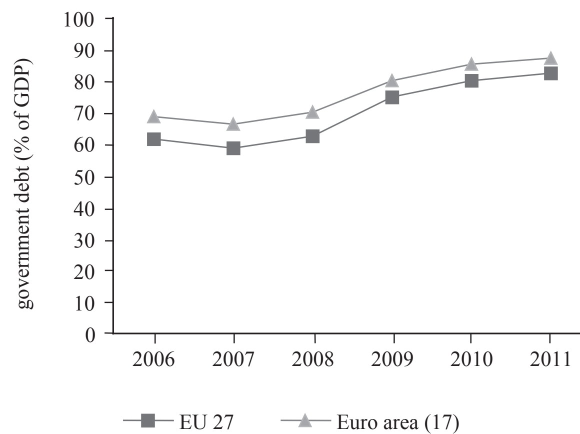

Fig. 9. Government debt (% of GDP)

Source: epp.eurostat.ec.europa.eu [16.09.2012].

It is particularly easy to identify the origins of the sovereign debt crisis in the so-called PIIGS countries.

Table 2. Origins of the debt crisis in PIIGS countries

Country/ 2011	Government debt (% of GDP)	Government deficit (% of GDP)	Reasons
Greece	165.3	–9.1	Poor competitiveness and diversification of the country's economy; high country indebtedness; inflated social benefits
Italy	120.1	–3.9	High economy indebtedness (government longer-term debt over 100% of GDP); unstable political situation – frequent changes in political structures impeding structural reforms
Ireland	108.2	–13.1	Banking crisis due to the deflation of the real estate bubble, public debt soared as a result of the government taking over the bank liabilities
Portugal	107.8	–4.2	High indebtedness of households as well as of the state; problematic structure of the economy resulting in low competitiveness
Spain	68.5	–8.5	The real estate bubble whose deflation resulted in the rising debt of households and caused the banking sector to plunge into problems; high unemployment rates in some regions
Belgium	98.0	–3.7	Debt soon longer-time over 90% of GDP; sluggish economic growth and political instability; problems in the banking sector revealed by the case of Dexia

Source: own based on data retrieved from epp.eurostat.ec.europa.eu [16.09.2012].

In general, over the recent years the Maastricht government debt has followed an upward trend.

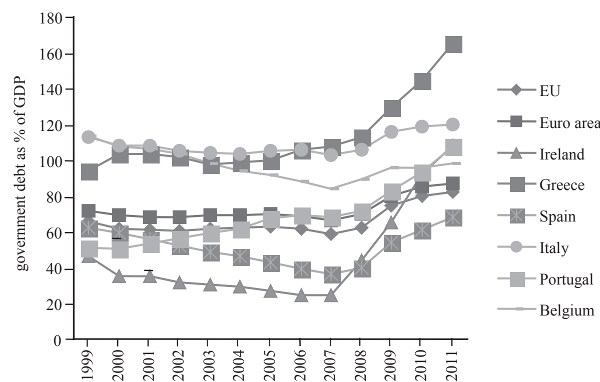

Fig. 10. Government debt in selected European countries (% of GDP)

Source: own based on data retrieved from epp.eurostat.ec.europa.eu [16.09.2012].

The highest increase in the debt to GDP ratio was observed in Greece (up to 20.3% in 2011), the second highest increase was seen in Ireland (up to 15.7% in 2011), and the third highest increase was in Portugal (up to 14.5% in 2011).

Differences among countries in terms of conditions for accessing financial markets are reflected by the cost of debt.

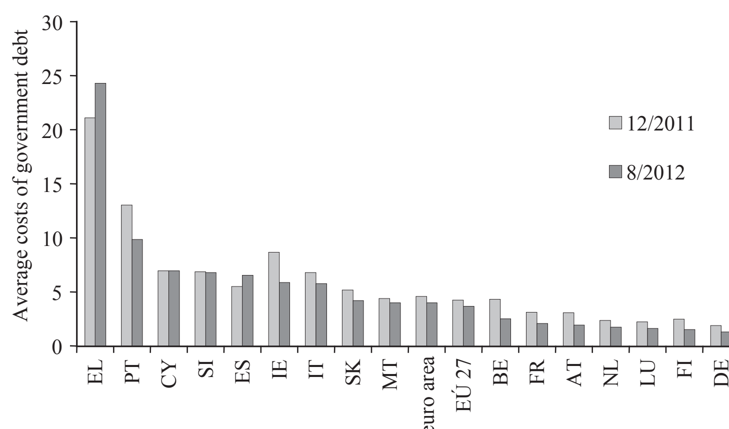

Fig. 11. The average cost of government debt

Source: own based on data available from epp.eurostat.ec.europa.eu [16.09.2012].

There are initiatives to implement many instruments – financial as well as legislative – in helping remedy the debt crisis in Europe. Only time will show if they are effective enough.

4. Some of the implemented solutions

The efforts to overcome the crisis in Europe have produced a number of measures such as: the European Financial Stability Facility (EFSF), the European Financial Stabilization Mechanism (EFSM), the European Stabilization Mechanism (ESM), the "Euro Plus Pact", the Fiscal Compact, or ECB monetary policy measures. The measures of ECB monetary policy have already been described in the preceding chapters.

4.1. The financial instruments

Initially, the EFSF used a simple back-to-back funding strategy. However, in November 2011, a diversified funding strategy was adopted using a liquidity buffer as a key component. As part of this strategy, the EFSF introduced a short-

term bill program and since the end of 2011, has held regular auctions of 3-month and 6-month bills. One consequence of the diversified strategy is that funds raised are no longer attributed to a particular country. Instead, the funds are pooled and then distributed to program countries upon request. Lending by country is shown in Table 3.

Table 3. EFSF – lending by country (in € billion)

Country	Already disbursed	Pending disbursement	Max. total committed
Ireland	12.0	5.7	17.7
Portugal	17.4	8.6	26.0
Greece	73.9	70.7	144.6
Spain			100.0
EFSF commitments and lending capacity: €288.3 bn			

Source: www.efsf.europa.eu [18.09.2012].

A cash reserve and a loan-specific cash buffer amounting to €3.7 bn was deducted from loans to the euro area member states (no longer required). The remaining EFSF's lending capacity is no less than €148 bn (€440 bn less €292 bn).

The EFSM has currently been activated for Ireland and Portugal, for a total amount up to €48.5 billion (up to 22.5 billion for Ireland and 26 billion for Portugal), to be paid over three years. Complementary loans have been provided by the International Monetary Fund.

In March 2011, a European Stabilization Mechanism (ESM) was approved that will replace both the EFSM and the EFSF. The ESM is expected to have an authorised capital of 700 billion euros of which 80 billion is paid-in capital and the remaining 620 billion will be raised, if needed, through the issuance of special ESM obligations to capital markets. The original ESM treaty stipulates that the capital should be paid in five annual installments; however, on March 30 2012 the Eurogroup resolved to accelerate the capital payments so that the full capital is paid by the first half of 2014. As soon as the ESM has received all its paid-in capital from the eurozone countries, it will be authorized to approve bailout deals for a maximum amount of €500 billion. The ESM lending capacity will be less in the final quarter of 2012, but it will gradually increase with each of the remaining four capital payments scheduled for 2013 and the first half of 2014.

4.2. The Fiscal Instruments

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union includes a number of provisions which build directly on previous European legislation:

– National "debt brakes"/"golden rules": The member states have committed themselves once again to a budgetary position "in balance or in surplus". They further commit themselves to pass a national law limiting the structural budget deficit to 0.5% of GDP, from which a deviation is only allowed in "exceptional circumstances". For countries with a debt-to-GDP ratio "significantly below 60% of GDP", the structural budget deficit may be as high as 1% of GDP;

– the European Court of Justice: a member state can now bring another member state before the European Court of Justice if it believes that another state has not fulfilled the requirements of incorporating a "debt brake" into national law. The European Court of Justice can inflict a penalty of up to 0.1% of GDP;

– the 1/20 rule which allows an excessive deficit procedure to be opened if countries with a debt-to-GDP ratio above 60% do not bring the ratio down quickly enough. The requirement is defined as an annual reduction of the debt ratio by 1/20 of the difference between the actual debt-to-GDP ratio and the 60% threshold. This rule is applied over a three-year average. In addition, countries are given a three-year grace period after the correction of their current deficit below the 3% target before the 1/20 rule comes into effect;

– reverse qualified majority: the Treaty allows for reverse qualified majority voting within the excessive deficit procedure, also in cases where this was not possible under existing European legislation.

It is rather obvious that the Treaty refers to, and builds on, existing European rules of fiscal policy making, especially those provided for in the original Stability and Growth Pact with its excessive deficit procedure, and the "Six Pack" with the 1/20 rule.

5. Summary

The ECB's non-standard instruments of monetary policy, described at length in this paper, have been criticized by many economists. The primary traditional transmission mechanism, "the interest rate channel", has been ineffective. The main argument is the growth of the European economy: the forecast for economy growth in 2013 is about 0.1%, while the unemployment rate remains the highest it has been in recent years. Economic problems have engendered social problems. The financial, economic and debt crisis has led to a trust crisis.

The European Central Bank plays a key role in the eurozone rescue procedures. The question is how long the ECB will be able to stabilize and unite the financial markets, and thus rescue banking sectors and governments. Are the economic, political and legislative measures effective enough? The initial proposal for integration – the monetary union – assumed a fiscal and political union as well. The current situation in the euro area will probably confirm that the prospective mone-

tary union is conditional on responsible fiscal policy, based on systemic supranational coordination and a fiscal and political union.

The vision of a stable and prosperous EMU is based on four essential building blocks:

– *an integrated financial framework to ensure financial stability*, particularly in the euro area, and to minimize the cost of bank failures for European citizens. Such a framework elevates responsibility for supervision to the European level and provides common mechanisms to address issues in the banking sector and to guarantee customer deposits;

– *an integrated budgetary framework* to ensure sound fiscal policy making at the national and European levels;

– an integrated economic policy framework;

– ensuring the necessary *democratic legitimacy and accountability* of decision-making within the EMU.

During the crisis, another tool has been widely discussed which should constrain short-term risk and potentially destabilizing transactions between financial institutions: the financial transaction tax. The implementation of the financial transaction tax should discourage financial institutions from engaging in excessively risky transactions and ensure that any losses attributable to the financial crisis are covered by the financial sector. The proposed tax rates are between 0.1%-0.01%, while the preferred tax rate is 0.05%. A study by WIFO (the Austrian Institute of Economic Research) predicts that a tax rate of 0.05% will reduce the volume of taxable transactions by about 65%. Table 4 predicts revenues from the financial transactions tax levied at 0.05%.

Table 4. Expected revenues from the tax on financial transactions

Country	Expected tax revenue
Great Britain (the EU country with the greatest contribution to financial transactions)	7% of the UK's GDP
Germany (the second greatest contributor to financial transactions in the EU)	1% of Germany's GDP
EU	1.5% of EU's GDP (most of Great Britain)
Worldwide implementation of the financial transactions tax	1.2% of global GDP

Source: "Official Journal of the European Union" 2011/C 44/14 [18.02.2012].

The EU countries' attitude could be considered as a negative one. The Association for Financial Markets in Europe (AFME), representing significant banks, has declared that the financial transaction tax will increase costs and impinge on economic growth. Supporters of the tax insist that it will stabilize markets by

imposing a constraint on short-term speculations and that countries will therefore gain a protection against interest rate pressures. In addition, countries can expect to obtain considerable income to finance public expenses. Opponents (including the London-based Adam Smith Institute) argue that the tax, if implemented, will entail destabilizing movements in foreign markets, a decline in stock prices, and liquidity shortages.

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Kryzys w eurolandzie – wybrane problemy i rozwiązania

Streszczenie. *Artykuł podejmuje kluczowe zagadnienia dotyczące Unii Gospodarczej i Walutowej, ulokowane na dwu płaszczyznach – na płaszczyźnie kryzysu bankowego (finansowego) oraz w wymiarze kryzysu zadłużeniowego. Szczególną uwagę poświęcono grupie tzw. krajów PIIGS, czyli państw o złej sytuacji budżetowej (Grecja, Portugalia, Hiszpania, Włochy, Irlandia). Wskazuje się przy tym na pozycję i działania Europejskiego Banku Centralnego (EBC), przede wszystkim te podejmowane w ramach polityki monetarnej, ale także i inne, niestandardowe działania, oraz omawia się ich wpływ na banki komercyjne i gospodarkę realną. Stawia się tu ciekawe pytanie o niezależność EBC. Następnie opisano pewne propozycje rozwiązań mogących pomóc w przezwyciężeniu obecnego kryzysu bądź zapobieganiu następnym, a konkretnie – instrumenty finansowe, takie jak EFSF (European Financial Stability Facility – Europejski Instrument Stabilności Finansowej) czy ESM (European Stability Mechanism – Europejski Mechanizm Stabilizacyjny), a także pakt fiskalny, stanowiący pierwszy krok do politycznej unii.*

Słowa kluczowe: *kryzys, polityka monetarna, dług, strefa euro*