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Resilience of the Euro

Elena Makrevska

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Abstract

The European Union (EU) nowadays is facing the most severe debt crisis. While Germany is rebounding very successfully from the economic recession Ireland, Greece and Portugal are faced with significant difficulties. The prospect of the single currency is drowning as a result of the debt and default fears that put a question mark over the whole EU. This paper critically assesses the widely used projections of the EU and appropriateness of different budgetary strategies in order to sustain the fiscal balances and stability of the Euro. This paper suggests that there are three possible solutions for "rescuing" the Euro. First, for the EU to continue with the strong enforcement of the rescue scheme. This is a serious step, having in mind that the burden of adjustment of the budget deficit will be inherited in future generations. Countries need to achieve higher rates of growth and stability in the medium term in order to cover today's losses. Second, elimination of the countries which are not in compliance with the Maastricht rules. If the countries stay, they won't have control over their monetary policies. If they leave the Euro zone, that will lead to an increase of the interest rates on a higher level than today. Either their citizens will face large declines in their living standards as their currency falls against the Euro or they will be demanding larger increases in wage that will lead to high inflation. There are two sides of the solution, and neither of them is easy. Third, exit of Germany from the Euro zone or the division of the Euro zone into two sub-regions (one with a strong currency and the other one with an adjustable exchange rate). All the solutions are in favor of further sustainability of the Euro. But in modern market economies, market powers make the final decision.

Introduction

The world was faced with the global financial crisis during 2007-2008, and in the years after the crisis (2009-2011) is still facing negative consequences. There is almost no country in the world that did not feel the strike of the crisis. Even thought it started in the financial sector, it slowly spilled over into the real and social sectors. The manifestation elements of the crisis are still present. Growth is showing stagnant rates, liquidity is drying up, credit growth is constrained, public debt ratios are raising, unemployment is high and financial risks still remain. In order to sustain the stability and "get back into the track", the world needs to reestablish the impaired external and internal balance.

The internal balance was disturbed as a result of the intensive fiscal stimulus that helped the countries to compensate the collapse of the private demand. The role of the growth initiator must belong to the private demand rather than budget spending. It is no longer maintainable that growth be financed with government revenues. On the other hand, the external rebalance must be made in the area of net exports. The situation with China and other emerging markets is that they rely on their net exports and exceed high rates of growth and trade surpluses. On the contrary, advanced economies, rely on their domestic demand which create trade deficits. The positions should be switched. Emerging markets should orient towards domestic demand and allow greater exchange rate flexibility. This implies that the coordination of the macroeconomic policies should be made on a national level, having in mind the effects taking measures on the rest of the world.

The most severe internal and external imbalances are noticed amongst the countries in the European Union. It seems that almost half of the member states of the European Monetary Union (EMU) are in debt crisis, which endanger the future of the euro (Nenovski, 2010, p.127). In the past twelve years, after the Euro was officially introduced (in 1999), the EMU has never faced so serious a problem like it does nowadays. The Maastricht criteria (the base principles of the EMU regarding the level of budget deficit, rate of inflation and level of public debt) have been violated for the first time by the PIGS countries (Portugal, Italy, Greece and Spain).

The prospect of the single currency is drowning as a result of the debt and default fears. The high level of budget and public debts of the mentioned EU member states have prevented their ability to finance the economy on

their own. Financial help from the rest of the EU member states is needed. The only problem is that according to the Lisbon treaty, the EU countries are not obliged to give financial help to one another, and can not make direct interventions (Sieberson, 2008, p.124). They can only approve loans to the countries that need to be financed or give warranties so those countries can take loans under favorable conditions. But, is that indirect financial help enough?

One of the problems lies in the lack of political coordination in the euro zone. Some authors (Verhofstadt, 2010, p.3; Grauwe, 2010 p.19) claim that following the Maastricht criteria is not enough for sustainability of the monetary union. What is needed is a strong political union. It seems that, Europe is about to make crucial decisions about the future of the European Union.

European Union Facing the Crisis

The current financial crisis is characterized by a long period of rapid credit growth, low risk premiums that cause unrealistic high asset prices and the creation of a real estate price bubble. After the bubble burst, the financial sector faced lower liquidity and lots of banks going bankrupt (Jackson, 2009, p.7). Problems in the financial sector overspill onto the real sector; causing credit restrains and lowering the confidence of the investors and households. The cross-border transmission happened almost immediately, due to the integrated financial system and globalization of the stock markets. According to International Monetary Fund- IMF (2010, p.21) the world output was showing decreasing trends from 2, 8% in 2008 to -0, 9% in 2009. The most affected countries were the advanced economies (USA had 2, 6 negative value of its GDP and EU, economic growth of -4, 1% in 2009).

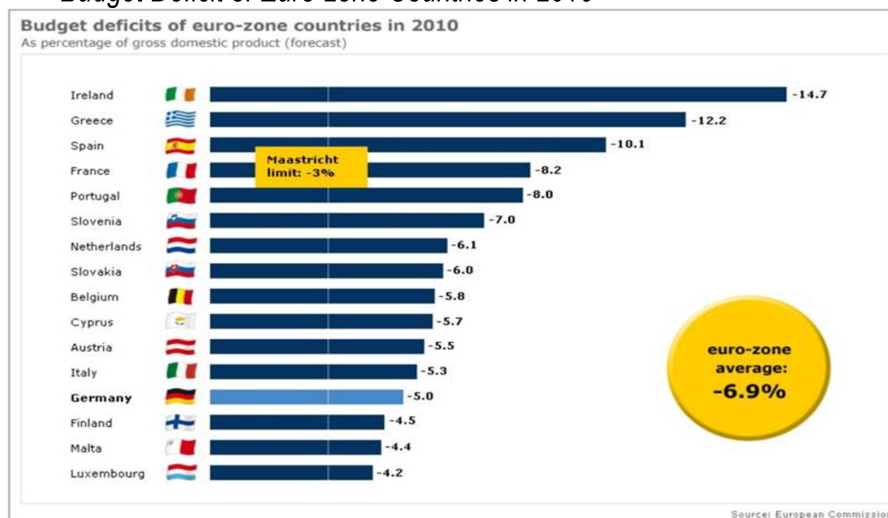
In order to face the consequences of the crisis and not to repeat the mistakes from the past (before the Great depression, it was supposed that the market by itself will solve the problems), policy makers acted aggressively on the market. Governments use (d) the fiscal stimulus to boost economic growth, and monetary authorities use (d) the method of quantitative easing (increasing the money supply by repurchasing government bonds and other financial assets by the Central Bank) and qualitative easing (the Central bank swaps high quality assets for poorer quality assets).

The budget spending becomes the main driving force of the growth. In a situation when consumption and investment are low, the expansive fiscal

policy is creating the growth. But, the intensive level of budget spending causes a deepening of the budget deficit. In the table below, rates of the budget deficit in EU countries for 2010 are given:

Graph 1.

Budget Deficit of Euro-zone Countries in 2010



Source: Mauldin J. (2010) *Europe Throws a Hail Mary Pass.* Retrieved May 8, 2011, from http://www.safehaven.com/article/16808/europe-throws-a-hail-mary-pass

The graph shows that even thought the Maastricht rules of the Euro zone presuppose that the budget deficit should not exceed 3 % of GDP, almost none of the EU countries abided by this rule in 2010.

Having in mind the crisis it is understandable why these huge budget deficits are created. The question is why is there such a difference between the volumes of the budget deficit between the countries. Some of them, such as Greece, Ireland and Spain, reached level of budget deficit of over 10% of the GDP. The current economic crisis reveals weaknesses of the financial and economic system of these countries. If we take Greece for example we can see that Greece joined the Euro zone on 1 January, 2001, as a 12th member after dramatically cutting inflation and interest rates, even though the budget deficit has never been below 3% even in that period. Even though the Greek economy had positive rates of growth before the crisis (4, 1% growth of

GDP in 2006), the economy in 2009 contracted by 0.3%, and the national debt has risen to €262bn, from €168bn in 2004 (Kolb, 2011, p.397). That decreased the country rating from A to BBB+ which pushed up the cost of borrowing. Also, other weaknesses of the financial system were revealed. Investment bank (Goldman Sachs) was accused of helping to cause the crisis by using derivatives contracts to disguise how much Greece was borrowing. Even though Greece took austerity measures that include freezing of the public sector pay and higher taxes (in February, 2010), the situation did not get better. The EU was forced to take some measures and help Greece with the rescue package. In April, 2010, (European Commission, 2010, p.58) the EU agreed on a 30 billion Euro rescue package for Greece. That was supported by the IMF pushing its bailout up to €45bn. The rating dropped to BB+ and Greece will need more help, beyond the 110 billion Euro that the country received during 2010. European leaders are preparing to let Greece use Brussels' emergency funding mechanisms, the European Financial Stability Facility (EFSF), to roll over its maturing debts. By august 2011, it is a big question of whether Greece needs additional money to solve its problems or it is just a wasted effort to save the country.

Ireland suffered from the economic crisis as well. Many flaws in the financial system, together with the decreased export (Ireland is an export led economy) lowered the economic growth. Ireland has had almost 250,000 net jobs lost in the recession to date (Watson & Renglig, 2010, p.22). Measures announced by the Irish government since July 2008 equate to a cumulative fiscal tightening of almost 9% GDP between 2008 and 2011.

These examples show that the EU authorities are trying to save these countries, by financial help and imposing measures for lower fiscal spending. The EU is trying to save the countries, because there are a number of mechanisms that transmit crises from one country to another i.e. that cause contagion that can jeopardise the stability of the euro.

The PIGS countries are in the Euro zone and face with macroeconomic problems as it was explained (large budget deficit, high debt level...). That decreases the investors` confidence, which lead into selling stock and bonds that can easily cause financial systems in the countries to collapse. High debt levels, low economic growth and low level of investors` confidence will decrease the competitiveness of the whole region, and will depreciate the value of the Euro. That is why the EU authorities have to save the counties from the debt problems that they are facing today. Some possible solutions

for saving the Euro especially with regards to the future of the indebted countries and the future of the Euro zone itself are elaborated below.

Possible Solutions for the Surveillance of the Euro

In any possible solutions for the surveillance of the Euro, one is sure: the fiscal stimulus has to stop operating as the main driving force for economic growth. Consumption and investment now have to take the lead. However, the real situation is that consumption and investment are still low, even though the governments are trying to restore their confidence. Unemployment is high and barely decreasing in most of the European countries. Unemployment is set to continue to rise until the first half of 2011 to a peak of more than 17 million people in Europe (European commission, 2010 p. 35). Together with the fact of uncontrolled debt in countries such as Greece, Spain and Portugal, the value of the Euro has dramatically fall.

Three possible solutions for "rescuing" the Euro can be suggested:

First, for the EU to continue with the strong enforcement of the rescue scheme. The last launched "financial package" by EU and IMF was 720 billion Euros, in May 2010. The stabilization scheme agreed upon by EU finance ministers and top officials after 12 hours of talks in Brussels consists of government-backed loan guarantees and bilateral loans worth up to €440bn ($568bn) provided by Euro zone members; a further €60bn supported by all EU members through expansion of an existing balance of payments facility; and up to €220bn provided by the IMF. The EU also has a temporary special fund called European Financial Stability Facility (EFSF), a rescue fund for troubled member states worth 440 billion Euros. This fund will be replaced in 2013 with the European Stability Mechanism that will increase the lending capacity to 500 billion Euros (Hall and Barber, 2010).

It seems that the financial help is constantly increasing in order to save their problematic countries. EU is not letting counties face the crisis alone. If countries do not bring down high post-crisis debt levels over the long run, they risk high interest rates, low private investment and growth, and fewer policy options to boost their economies in the face of another economic downturn. In that direction, the IMF reports that policies to reduce deficits will be a key factor in the projected decline in the overall deficit of advanced economies by about 1¼ percent of GDP in 2011. That would mean according to my opinion that the fiscal sector needs to be supported by reforms in the health and pension care systems, strengthening the fiscal rules and control over the

institutions charged with government budget spending. Economic coordination and reforms in each economy is a main precondition for saving the Euro zone. Fiscal consolidation (decreasing the rates of budget deficit) will dissimulate short term growth but, if it is followed by the reforms from the Basel Committee on Banking Supervision that would help financial markets and institutions to offer support for the consumption and investment which is essential for medium and long term growth.

This is a serious step, having in mind that the burden of an adjustment of the budget deficit will be inherited by future generations. Countries need to achieve higher rates of growth and stability during the medium term in order to cover today’s losses. It seems that even though countries are aware of the current situation, they are facing problems in order to cut the budget spending (reform problems, protests from the population….). So, it is more likely that the EU will continue to finance the indebted counties and try to stimulate the countries to reduce their budget deficits (and force the measures for fiscal adjustment). That will help the individual countries (as well as the EU as a whole) to regain the competitiveness and achieve positive rates of growth.

The second solution is that the EU instead of growing toward Federalization it will go a step back, transforming into a free trade association. That will bring back the old currencies and will leave the choice to the monetary authorities in each country. That of course, will be efficient in the short term but it will make the EU less competitive in the long run on the international market. If they leave the Euro zone, that will lead to an increase of interest rates on a higher level than today. Either their citizens will face large declines in their living standards as their currency falls against the Euro or they will be demanding larger increases in wage that will lead to high inflation. The most important thing is that that economic and political stability of Europe, can be destabilize.

But if we look forward, it is logical to expect that the EU will grow into a Federacy. That can also be one of the solutions. In that case, the EU will have a unique fiscal policy. That also presupposes a unique external and security policy. The most important thing in the process of federalization is homogenization of the regulation and control of the financial institutions in the EU, regulations for the balance of payment and harmonization of the taxation system.

What would be the use of this federalization? It would help with EU regulations, to have better enforcement of the structural reforms and hopefully better results. For example, structural reform for increasing the flexibility of the

labor market (in the region with same regulation) will increase the competitiveness of the region. In the history of monetary unions, there is an unsuccessful example of the Scandinavian Monetary Union- SMU, (formed by Sweden and Denmark in May, 1873 and Norway 1875). Among the other reasons, it seems that when Norway became independent, the irate Swedes dismantled the monetary Union (Sharp, 2005, p.7). The individual interest bit the interest of the monetary union. That raises the question whether the countries in the EU are ready to sacrifice their own interest for the sake of the Union?

Nonetheless, coordination is needed in the fiscal sector (consolidation of the budget deficits), and also in the area of monetary policy. The monetary policy should also be adjusted in order not to proceed with further quantitative and qualitative easing (explained previously), but rather to be followed by banking standards that will support healthy credit growth. In that sense, it is important to be proceeded by the financial reform: regulation of the process of securitization, regulation of the "too big to fall" institutions, cross border issues and other issues that were among the reasons that caused the financial crisis.

So far, coordinated policy responses made progress into ensuring liquidity in the system and restoring the confidence of the investors and households. The challenge ahead is to be continued with the future coordination of the macroeconomic policies in order to return the growth rates to the pre-crisis level. Whether the EU will be in the form of a free trade zone, monetary union or political union, coordination is needed.

The third solution will be if the Euro zone split into two regions. An economically stable core of Europe will be one region and the "profligate" countries in the Mediterranean will be members of the other region. The stable core would consist of countries like: Germany, France, Netherlands, Belgium and Luxemburg. The other region of Mediterranean countries would consist of Greece, Portugal, Spain and Italy. According to this solution there will be a North- South divide, which will stimulate the Mediterranean countries to reduce their budget deficit and to join the South region.

But, where will Ireland belong? According to the economic performances it belongs in the South, but according to the geographic location it is in the North. The separation of the two regions cannot be that easy even in the terminological sense. Growth in the Mediterranean economies and Ireland is forecast to average only 0.6% combined per annum over 2010-12, compared to 1.8% in Germany, France and the Benelux. This compares to the five years prior to the crisis when Greece, Ireland, Portugal and Spain together grew at

an average rate of 3.5% per year while their northern neighbors grew by less than 2% per year (European commission, 2010, p.24). That shows that the growth in the Mediterranean countries was not based on labor productivity, but rather that the growth was based on higher borrowing and high consumption. The main difference between the two regions, North and South, is that the Mediterranean counties and Ireland will have lower income levels. This divide will stimulate convergence in the prices in the following years, as Mediterranean counties and Ireland reduce their deficits and improve their performance.

Still, breaking up the Euro is not impossible but it is very costly. Leaving the most indebt countries out of the Euro zone or dividing the EMU into two regions is technically difficult and it will cause many expenses (it took three years to introduce the euro). Except that, it will bring economic cost in a sense that there will be general panic amidst the population, and depositors will run on deposits which will worsen the situation in the banking and financial sector. The worst fear is that it will destabilize Europe (political risk).

Conclusion

All three solutions have both positive and negative sides. Still, the final conclusion is that budget spending has to stop being the main driving force of the GDP growth. Fiscal policy needs tightening during 2011. As we explained in the text, the budget spending only “put oil to the fire” or in other words revealed the weaknesses of the financial and economic systems of the countries. Even though the countries hoped higher budget spending would help the economy to grow, that only brought high public deficit with no developmental component. The fiscal consolidation has to be deliberate precisely, in order to be able to sustain debt during the medium term.

Along with the fiscal consolidation, coordination with the monetary policy is needed more than ever. That will help the economy to sustain and grow healthy financial systems that will create and support productive and quality investments. Along with that, the economy will generate high rates of real growth. Coordination in the macroeconomic polices will also mean high banking standards and financial reform in the areas that failed during the economic crisis (regulation of the process of securitization, regulation of the “too big to fall” institutions, cross border issues etc).

In the meanwhile while coordination is achieved, it is more likely that the EU will continue to finance the indebted counties, and “hope” that they will

use that period to reduce their budget deficits (with measures for fiscal adjustment) and make structural changes in their economy in order to regain competitiveness on the market.

According to my opinion, the EU will choose the first solution and will continue to financially support the member states. According to the explanation for the third solution, breaking up the Euro is not impossible but it is very costly. It would bring many expenses and risks, and the biggest one is the political risk for destabilization of the EU. In this way the EU will go a step backwards. Europe needs synchronized action of the fiscal and monetary policy (even if that coordination means federalization of the EU) in order to sustain the growth and the stability of the EU as a monetary union.

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