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Monetary integration and the Eurozone:

Background to the sovereign debt crises and the way forward

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1. EU members and eurozone members

European Union (EU)

The European Union (EU) is a political and economic grouping comprising 27 Member States built on economic cooperation that began in the post-World War II period as the European Coal and Steel Community (ECSC). Membership gives access to the single market of the EU, thus extending the EU's 'four freedoms' – the free movement of goods, capital, services, and people – to Member States.

Economic and Monetary Union (EMU)

EMU, also known as the eurozone or the euro area, is a grouping of Member States within the EU focused on economic convergence in three stages, to be completed with the adoption of the euro. There are currently 17 countries in the eurozone:

> Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

Eurozone membership – the adoption of the euro currency – is deemed by the respective treaties of accession as the eventual stage of integration into the Union. In other words, all EU Member States are required to adopt the euro and join the eurozone eventually. To do so, they must meet certain convergence criteria.[1] Three EU Member States, the United Kingdom (UK), Sweden and Denmark, have obtained special opt-outs from the eurozone.

2. Developments leading to EMU

A. European Monetary System (EMS)

Under the EMS established in 1979, the currencies of all the Member States, except the United Kingdom, participated in the exchange rate mechanism (ERM), preventing movements greater than 2.25% around parity in exchange rates with other Member States.

The EMS consisted of two major components:

1. The creation of an artificial unit of account, the European Currency Unit (ECU), which was *not* a medium of exchange. That is to say that neither ECU notes nor coins were issued or used to conduct transactions (before 2002).
2. A managed float exchange rate system known as the ERM

Deficiencies

It became increasingly clear that the potential of the European Single Market could not be entirely fulfilled if high transaction costs resulting from currency conversion and the uncertainties linked to exchange-rate fluctuations remained. Furthermore, many economists denounced what they termed the "impossible triangle/trinity" – free movement of capital, exchange rate stability and independent monetary policies were incompatible in the long term.

[1] "The euro. Who can join and when?" European Commission, http://ec.europa.eu/economy_finance/euro/adoption/who_can_join/index_en.htm

Speculative attacks continued well into 1993. On 16 September 1992, the UK left the EMS while countries like France saw their currencies come under such heavy attack that the exchange bands were widened so much that they were effectively floating currencies.

B. ERM (Exchange Rate Mechanism) II

The European Monetary System ceased to function in May 1998, when Member States fixed their mutual exchange rates as one of the very first step towards participating in the Economic and Monetary Union (EMU). The succeeding ERM II, launched on 1 January 1999, discarded the ECU as the euro became an anchor for the ERM II currencies.

C. Economic and Monetary Union (EMU)

The EMU was introduced in three stages:

Stage 1: the free movement of capital between Member States;

Stage 2: convergence of Member States' economic policies and strengthening of cooperation between Member States' national central banks.

Stage 3: the gradual introduction of the euro as the single currency of the Member States and the implementation of a common monetary policy under the auspices of the European Central Bank (ECB).

Stability and Growth Pact (SGP)

Adopted during the second stage of the EMU, the SGP affirmed that countries seeking to adopt the euro should seek to balance their budgets averaged over the course of the business cycle.

The pact's annual criteria:

i. Deficits shall not exceed 3% of GDP unless GDP has declined by at least 2%
ii. National debt shall be lower than 60% of GDP or approaching this value

Between 1999 and 2007 however, deficits over the 3% threshold were registered 30 times, leading to criticism that budgetary and fiscal discipline was too lax.[2] In the same period, however, the eurozone as a whole remained above this debt ratio, due mainly to the larger Member States like Germany and France.[3]

3. Arguments for the euro as a common currency

a. Elimination of currency conversion costs

The increase in GDP resulting from the elimination of these costs has been estimated at 0.4% on average.

b. Increased competition and efficiency

A single currency brings more transparency in prices and places downward pressure on prices in higher-cost firms and countries.

c. Elimination of exchange rate uncertainty among Member States

Massive speculation could still occur within ERM framework. A single currency, conversely, encourages investments by firms that trade between Member States and provides certainty in calculating costs and revenues from such transactions.

d. Increased inward investment

The eurozone attracts investment from outside, because there is no fear of internal currency movements.

[2] Iain Begg (2012), "The EU's response to the global financial crisis and sovereign debt crisis," Asia Europe Journal 9: 114.
[3] Ibid, 115.

e. Lower inflation and interest rates

A single monetary policy directed by the ECB forces convergence in inflation rates. The low average inflation rates in eurozone countries have thus resulted from the ECB's autonomy. Markets are thus persuaded of the euro's strength relative to other currencies, resulting in lower long-term interest rates. This, in turn, encourages investment in eurozone countries, by Member States as well as the world at large.

4. The sovereign debt crises, 2009 to present

Many EU Member States experienced the global financial crisis that followed the collapse of Lehman Brothers in the United States in September 2008. The Lehmann collapse brought about a loss of confidence within the international financial system. As a result, many governments acted swiftly in a bid to shore up equity and to guarantee deposits. The government of Ireland was quick to offer a €440 billion blanket guarantee to depositors, which later proved to be a fatal misstep. In the UK, equity injections, guarantees and central bank liquidity were deployed to support several of the largest banking groups.

By early 2009, the area saw some signs of normalisation which unfortunately did not last long. Having experienced such a slump in growth that decreased tax revenues, Greece could no longer sustain the high budget deficit it had maintained in secret for years and in December 2009, Greece admitted that its debts had reached the €300 billion mark. The highest public debt in its modern history, Greece's budget deficit stood at 113% of its GDP and nearly double the limit permitted within the eurozone, as spelt out in the Maastricht Criteria. While the Greece promised to curb their deficit through austerity, concerns rose over the other heavily-indebted eurozone countries of Portugal, Ireland and Spain.

Bailouts

To date, five EU Members States have requested for bailouts – Greece, Ireland, Portugal, Spain and Cyprus. Except for Cyprus, for which bailout negotiations are ongoing, they have all been agreed to.

On 2 May 2010, the EU and the International Monetary Fund (IMF) agreed on a €110 billion bailout package for Greece. Ireland was offered a similar package of €85 billion in November 2010. In February 2011, eurozone finance ministers created the European Stability Mechanism, a permanent contingency bailout fund worth approximately €500 billion. Two months later, Portugal admitted to being unable to cope with its finances and requested the EU's help, which came the following month in the form of a €78 billion bailout.

A second bailout package was agreed for Greece in March 2012. In June 2012, the governments of Spain and Cyprus requested for bailouts for their banks – a package has since been agreed for Spain.

Note that these bailouts are interest-bearing loans that come attached with conditions – they are *not* grants or aid. In the case of Greece, subsequent instalments of bailout funds were withheld from the state until a second, more drastic round of austerity measures were adopted, including the sale of €72 billion in state assets. Ireland's receipt of its package was made possible by the proposal of a four-year austerity plan involving deep cuts in spending and public-sector jobs, a lower minimum wage and higher taxes.

What a Greek default would mean for the eurozone

A precedent set by a Greek default might spread to other members of the single currency, as creditors become concerned that the other crisis-stricken countries (Ireland, Portugal, Italy and Spain) will default as well, and that banks and central banks, which hold high volumes of government bonds, would collapse (known as the 'contagion effect'). If Greece were to leave the eurozone and reintroduce the drachma as the national currency, it may be hit by much higher inflation. The European Central Bank's holdings of sovereign debt would suffer massive losses, which would largely be transferred back to Germany and France. Even the original €110 billion bailout of Greece would face a write-down.

5. Greece – A sovereign debt crisis

What got Greece into the crisis?

Public sector expansion

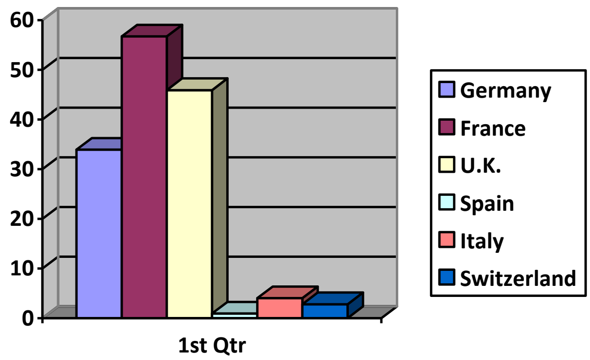
Between 1972 and 1973, Greek inflation rates rose from 4.3% to 15.5%. The situation worsened with the oil crisis of 1973, due to Greek reliance on imported oil. This set the stage for the restructuring that was to come in the following decade.

Deindustrialisation occurred in the 1980s, as was the case in many Western European countries, with manufacturing moving out of Europe to countries with lower labour costs. Then-Greek Prime Minister Andreas Papandreou chose to invest in the country’s public sector, financing this expansion through deficit.

Unrestrained borrowing

Due to eurozone membership, nominal interest rates declined from about 20% in 1994, when Greece first announced its desire to join the eurozone, to less than 3.5% in early 2005. This encouraged borrowing, and built upon the debt which Greece had accrued since the 1980s.

Exposure to Greek Debt (Sept 2011, in $bn)[4]



Sustaining a welfare state

While welfare systems such as in Sweden have been successful, Greece faced several challenges in sustaining its welfare system which aggravated its economic troubles. Tax evasion was rampant and has been estimated to constitute 12-15% of GNP.[5] Furthermore, a low birth rate and rapidly aging population have the effect of increasing old-age assistance expenditure despite the government's attempts in cutting back. The fact that pensions in Greece are so large as to provide households with as much as 24.1% of their disposable income compounds these difficulties.[6]

Problems aggravated by the constraints of monetary union[7]

Membership in the eurozone also means a loss of control over monetary policy. Unlike countries with their own currencies, eurozone countries cannot increase the money supply of euros (otherwise known as 'printing money', or as in the

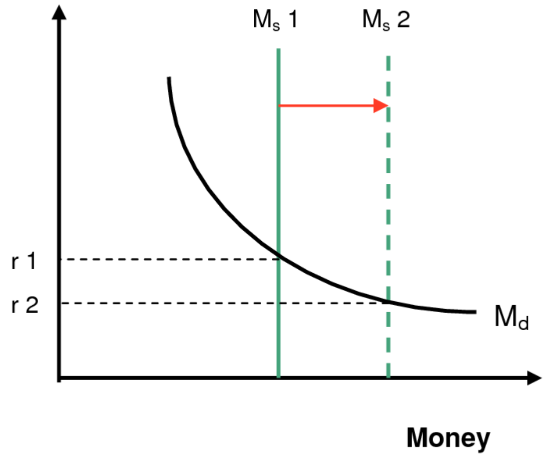
[4] "Infographic: The EU Debt Crisis in Charts," Forex News Now, http://forexnewsnow.com/infographic-the-eu-debt-crisis-in-charts/

[5] Bruno Waterfield, "Greek chief tax inspector says Christine Lagarde right to criticise evasion," *The Telegraph*, 8 June 2012, http://www.telegraph.co.uk/finance/financialcrisis/9319799/Greek-chief-tax-inspector-says-Christine-Lagarde-right-to-criticise-evasion.html

[6] Manos Matsaganis, "The welfare state and the crisis: the case of Greece," *European Consortium for Political Research*, http://www.ecprnet.eu/MyECPR/proposals/reykjavik/uploads/papers/2180.pdf

[7] Martin Feldstein, "The French Don't Get It," *Project Syndicate*, December 28, 2011, http://www.project-syndicate.org/commentary/the-french-don-t-get-it

US, quantitative easing) to fulfill their debt obligations. If they could 'print money', interest rates would fall and borrowing would rise.



Due to this loss of control over monetary policy, a eurozone country like France, with budget deficit 5.8% of its GDP, is less able to ease the risk of default as compared to the UK, despite its budget deficit of 8.8% of GDP, as the former has lost the flexibility of printing and devaluing its own currency to pay off creditors. In theory, the currency devaluation that follows the printing of money makes exports cheaper vis-à-vis a country's trade partners, improves the balance of trade and raises GDP.

The role of Germany in measures to resolve the crisis

The aversion towards 'printing money' as a solution and to let inflation loose in Europe is coloured by historical events. After the World War I, the German government attempted to meet domestic spending requirements and war reparations commitments by printing money. The result of this was that in 1919, the volume of currency in circulation increased by 80%, while prices rose by 91%. The strategy was repeated once more in 1921, and by 1923, the annual rate of inflation reached 7 trillion per cent. With hyperinflation, the life savings of many Germans were wiped out, real incomes fell rapidly and many became bankrupt. This period of extreme economic dysfunction, compounded by the effects of the Wall Street Crash a few years later, is often seen as a factor which had pushed the people towards electoral support for the Nazi party, which promised economic regeneration.

Adoption of the euro enabled the southern European countries to benefit from unprecedentedly low interest rates which fuelled a debt-driven boom. Germany, on the other hand, has become an exporting giant since the establishment of the eurozone, counting the heavily indebted states among its export markets. Additionally, while the booms had caused wages to increase in states such as Greece, the German trade and labour unions had held German wages steady, creating the current competitive price disadvantage. This loss of competitiveness is the foremost reason southern Europeans have been finding it so much harder to export than Germany.[8]

Such factors, coupled with Germany's key role in EU policy-making, have given rise to accusations that Germany has benefitted from the eurozone's troubles. One such allegation is that Germany utilised the monetary union to allow the other states to acquire loans irresponsibly at low rates, thus encouraging demand for its exports.[9] However, one should also consider that no other country has taken on such substantial obligations as Germany to stabilise the common currency. Furthermore, in the event that it or the ECB (of which it is a principal owner) should have to write off Greek debt, it stands to lose billions of euros. Its guarantee of more than 25% or €211 billion of the European Financial Stability Facility (EFSF) means exposure to risk from countries such as Portugal.[10]

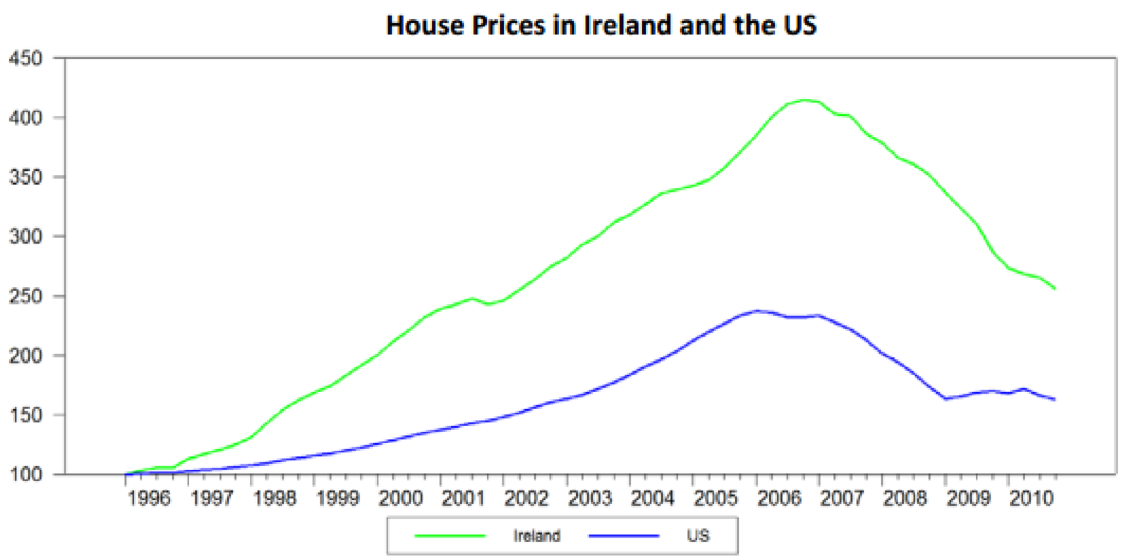
[8] Kevin Peachey, "eurozone crisis explained," *BBC News*, June 18, 2012, http://www.bbc.co.uk/news/business-16290598.
[9] George Friedman, "Germany's Role in Europe and the European Debt," *Stratfor Global Intelligence*, January 31, 2012, http://www.stratfor.com/weekly/germanys-role-europe-and-european-debt-crisis.
[10] Sven Böll, "Why Germany Isn't Benefiting from Euro's Woes," *Spiegel Online International*, February 7, 2012, http://www.spiegel.de/international/europe/debt-crisis-myth-why-germany-isn-t-benefiting-from-euro-s-woes-a-813667.html

6. Ireland – from property boom to banking crisis

After a period of sustained economic growth, low unemployment and budget surpluses, its debt to GDP ratio stood at 25%. Yet, in a few short years, the bust of the property bubble and a profound banking crisis would devastate the Irish economy.

The property bubble[11]

Rapidly increasing incomes, coupled with the availability of mortgage finance at historically low rates, fuelled the demand for housing, which created a boom in the construction industry beginning in the early 2000s. Between 2000 and 2006, housing prices more than doubled. The over-valued property prices proved to be unsustainable. These prices began to fall in early 2007, severely depressing the demand for new houses. This, in turn, resulted in high unemployment in the Irish construction sector. Since the construction industry had accounted for 13.3% of national employment in 2007, this drop in construction-related employment caused ripples in the Irish economy.



[11] Karl Whelan, "Ireland's Sovereign Debt Crisis," Working Paper 11/09 (University College Dublin, 2009), http://www.ucd.ie/t4cms/WP11_09.pdf

Taxation, government revenue

During the property boom in the 1990s, with tax revenue from asset-based taxes rising steadily, the government decided to lower income taxation rates. Thus, when the construction sector had come to a near halt, the government found itself rapidly losing tax revenue.

2008 banking crisis

The decrease in employment that occurred in the construction industry resulted in a loss of income tax revenue, instead causing government expenditure to rise from the payment of unemployment benefits. The property bubble was itself fuelled by a combination of factors. Since the 'Celtic Tiger' years of Ireland's rapid economic growth from 1995 onwards, corporation tax had stood at a modest 12.5%,[12] a feature which has been blamed for causing distortions in the tax system and an overdependence on property tax for revenue during the boom years.[13] Furthermore, Irish banks had obtained funds for the property boom from bonds sold to international investors. Many of the loans from Irish banks to property developers were made based on the expectation that property rises would continue to rise. When this ceased to be the case in early 2007, all three major domestic banks suffered massive losses. As downgraded credit ratings caused international investors to be increasingly wary of Irish banks, they experienced difficulty in raising funds through bonds, eventually turning to the government for aid.

7. The way forward

The EU has proposed various measures to recover from the crisis, most notably with the adoption of the 'Six-Pack' and the Treaty on Stability, Coordination and

[12] Paul Gillespie, "At the receiving end—Irish perspectives and response to the banking and sovereign debt crises," Asia Europe Journal 9 (2012): 136, doi:10.1007/s10308-012-0307-5

[13] Thomas Molloy, "Ireland's low corporate tax helped fuel banking crisis, claims Merkel," *Irish Independent News*, 24 February, 2011, http://www.independent.ie/business/irish/irelands-low-corporate-tax-helped-fuel-banking-crisis-claims-merkel-2554023.html

Governance (TSCG). The two items, both seeking to redefine EU fiscal governance, shall run in parallel with each other.

The 'Six-Pack'

On 13 December 2011, a reiteration of the Stability and Growth Pact came into being, with an additional set of measures (officially dubbed the 'Six-Pack', in reference to the five regulations and one directive prescribed) aimed at economic and fiscal surveillance of EU countries. The primary deterrent of non-compliance comes in the form of economic sanctions.

Some key points on the 'Six-Pack':

- States not in compliance with the Stability and Growth Pact's criteria should comply to the European Council's recommendations to correct their excessive deficits, failing which a sanction will be imposed
- States with debt to GDP ratio of greater than 60% will be deemed as non-compliant, even if their deficit is within the 3% limit if the gap between its debt level and the 60% reference is not reduced by 1/20th annually. States are given country-specific deadlines for correction of their excessive deficit.
- An "expenditure benchmark" which places a cap on the annual growth of public expenditure according to a medium-term rate of growth has been established to guide Member States towards country-specific medium-term budgetary objectives (MTO). This cap, however, should not constrain public expenditure levels as long as they are effectively financed.
- In terms of enforcement, continuous non-correction can lead to financial sanctions (an interest-bearing deposit of 0.2% of GDP as a rule).

EU Fiscal Compact

The EU fiscal compact refers to the fiscal portion of the TSCG, which will come into force on 1 January 2013. The treaty itself is binding on all eurozone Member States, and partially binding to EU Member States, except the UK and the Czech Republic whose leaders refused to sign it.

Some key points of the fiscal compact:

- Member States agree to commit themselves to maintaining budget balance or surplus in the long run, either by passing a national law or constitutional amendment that limits the structural budget deficit to 0.5% of GDP. Members with a debt-to-GDP ratio “significantly below 60% of GDP” will be allowed a structural budget deficit of up to 1% of GDP.

- The European Court of Justice (ECJ) may punish failure to properly implement these budget rules with financial sanction (0.1% of GDP). A member state can now bring another before the ECJ for disregard of these rules.

- Members are required to achieve an annual reduction of the debt ratio by 1/20 of the difference between the actual debt-to-GDP ratio and the 60% threshold, over a three-year-average. Furthermore, a three-year grace period is given after the correction of their current deficit below the 3% limit before the 1/20 requirement comes into effect.

Criticism

The ECJ sanctions have been criticised as potentially being ineffectual as a budgetary discipline enforcement mechanism, given that the fines imposed may be too small to serve as a deterrent. Another criticism is that the target of balanced budgets may make for excessively tight fiscal policy that leaves insufficient room for investment. Rather than demanding a balanced budget over the cycle, the fiscal compact’s rule does not take into account investment returns in the future which help to service debt.

Other strategies to solve the sovereign debt crises

1. Financial Transaction Tax (FTT)

    The FTT was a proposal made by the European Commission to introduce a financial transaction tax within the 27 Member States of the EU by 2014. The tax would impact financial transactions between financial institutions charging 0.1% against the exchange of shares and bonds and 0.01% across derivative contracts. The financial transaction tax will reduce Member States' GNI contributions to the EU budget by 50%.[14]

[14] “Press Release,” *European Parliament*, March 23, 2012,

2. Eurobonds

   Where international investors purchase bonds from the eurozone as a whole, the proceeds from which are redirected to national governments to finance public expenditure. Eurobonds are to be guaranteed by the eurozone countries. However, this has been met with objection from Germany, which fears being burdened by the debts of other Member States.

Government intervention: austerity measures

In early 2010, the use of austerity measures was fuelled by the belief that such cuts, despite their negative effects on employment, would restore confidence in the markets and thus increase consumer and business spending.[15] At present, while the European Commission continues to urge Member States to apply austerity economics, unemployment levels have risen to 11% in the eurozone, a 15-year high.[16]

Austerity measures in various EU Member States

Greece

On 13 February 2012, the Greek government approved an austerity package which included a 22% cut in the benchmark minimum wage and 150,000 public sector layoffs.

Ireland

In order to meet the conditions for the bailout, government spending in Ireland has been cut by €4 billion. All public servants received pay cuts of at least 5%.

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http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/300

[15] Paul Krugman, "Pain Without Gain," *New York Times*, February 20, 2012, http://www.nytimes.com/2012/02/20/opinion/krugman-pain-without-gain.html

[16] Ian Traynor, "More austerity and unemployment ahead, warns European Commission," The Guardian, May 11, 2012, http://www.guardian.co.uk/business/2012/may/11/more-austerity-unemployment-europe

Social welfare was reduced, and child benefits were cut. Value Added Tax (VAT) also rose to 23%.

United Kingdom

In the UK's 2012 budget, Chancellor George Osborne announced measures to ease taxes, such as a 5% cut to the top rate of tax and a rise in the personal income tax allowance threshold, but which also cut the personal income tax allowance pensioners receive, reduced child benefit and raised taxes on tobacco, among other items. These inspired the biggest demonstration in London since the Iraq war.

France

France, under the new Socialist president Francois Hollande, is set to increase taxes on big corporations and those whose earnings exceed €1 million a year. However, the president also wants to raise the minimum wage, hire 60,000 more teachers and lower the retirement age from 62 to 60 for some workers.

The Franco-German Debate

German Chancellor Angela Merkel has pushed for austerity measures as a solution to the sovereign debt crises. Commentators have attributed the German belief in austerity to its experience since the fall of the Berlin Wall. In the early years after the reunification of two Germanys, billions of German marks had been injected to aid growth in the regions of former East Germany. The expansion was paid for by keeping wages constant for over a decade.[17]

Former French president Nicolas Sarkozy had been an ally in Merkel's efforts, but the socialist François Hollande who replaced him at the polls in May 2012 has proposed differing options. One key difference lies in the issue of eurobonds.[18] While Hollande believes that the recapitalisation of banks is

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[17] Graham Satchell, "German faith in austerity explained," *BBC News*, May 15, 2012, http://www.bbc.co.uk/news/world-europe-18068187

[18] These are porposed government bonds to be issued in Euros jointly by the 17 eurozone countries.

achievable through the sale of eurobonds, Merkel has rejected the idea on the grounds that these would reduce the incentive for weaker European economies to carry out the reforms needed to improve their competitiveness.[19] The current French government is confident of their solution of growth measures and EU-level stimulus spending. French Finance Minister Pierre Moscovici has stated that it will be possible for French public spending to fall within the 3% limit by 2013, without resorting to austerity.[20]

Some conciliation between the two perspectives was forged during the EU Summit on 22 June 2012, with Germany, France, Italy and Spain agreeing to push for a €125 billion growth package, including:

i. Increasing the capital of the European Investment Bank by €10 billion, which would enable it to increase its lending capacity by several times that amount;
ii. The creation of pan-European "project bonds" - common debts used to finance specific investment projects such as the construction of pan-European transport networks. However, the German position on eurobonds remained unchanged;[21]
iii. An agreement to let the ECB buy the debt from the banks directly rather than buying government bonds.

This development comes after Spain's second bailout of €100 billion, agreed to in June 2012, which did not help bring down the rates that the Spanish government has to pay for its bonds.[22] More still needs to be done, and the eurozone crisis is not over as yet.

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[19] Carol Matlack, "Hollande vs. Merkel: French Resistance Holds Firm After Seven Days," *Bloomberg Businessweek*, May 22, 2012, http://www.businessweek.com/articles/2012-05-22/hollande-v-dot-merkel-french-resistance-holds-firm-after-seven-days

[20] "France finance minister vows to bring down debt without austerity," *Euronews, June 4, 2012*, http://www.euronews.com/2012/06/04/france-finance-minister-vows-to-bring-down-debt-without-austerity/

[21] Norman Smith, "Eurozone four leaders agree economic growth package," *BBC News*, June 22, 2012, http://www.bbc.co.uk/news/world-europe-18546584

[22] Raphael Minder, "Spain to Accept Rescue From Europe for Its Ailing Banks," *New York Times*, June 9, 2012, http://www.nytimes.com/2012/06/10/business/global/spain-moves-closer-to-bailout-of-banks.html?pagewanted=2&_r=1&hp

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