

# Broken Forever? Addressing Europe's Multiple Crises

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## Summary points

- Greece's recent bailout is just the latest stage in a deep-rooted crisis for Europe's monetary union that was exacerbated by the global financial crisis. Without measures to deal with the current crisis and to address the underlying problems of the euro area, it is hard to see EMU surviving in its current form.
- Countries in the euro periphery have suffered from long-standing fiscal problems, under-performing economies, imbalances and a widening gap in competitiveness with 'core' countries.
- These periphery countries now face problems requiring a combination of urgent and long-term measures. In the immediate future they have to convince markets that their fiscal plans will reduce debt without a collapse in growth, and to normalize their banks' access to market funding. In the longer term they must achieve sustainable increases in growth, improve competitiveness and rebalance their external payments positions. They must adapt to the constraints of the single currency.
- Reforms are needed to help the periphery countries live with the euro. At the same time the incentives for correcting imbalances need strengthening, with the burden shared more equitably between deficit and surplus countries, in order to create an effective model for growth within the euro area.

## Introduction

Despite the latest bailout for Greece, Europe's sovereign debt crisis, which began in 2010, continues. Rooted in the financial and economic imbalances within Europe, the structural weaknesses of its model of growth, and the differences within the region, the crisis has exposed the deficiencies in the governance of the European Monetary Union (EMU) and shown the limits of its framework of policy cooperation.

‘ A monetary union that was not accompanied by a fiscal union could only succeed by putting in place robust governance and strong rules. Yet over many years rules in the euro area have been disregarded for the sake of politics ’

The euro crisis did not develop overnight, but incubated over a number of years. Since EMU's inception the political nature of European integration has taken priority over sound economic principles. It has always been clear that Europe falls short of the requirements for an optimal currency area as envisaged in economic theory.<sup>1</sup> A monetary union that was not accompanied by a fiscal union could only succeed by putting in place robust governance and strong rules. Yet over many years rules in the euro area have been disregarded for the sake of politics.

Two of the countries that ended up at the centre of the sovereign debt crisis, Greece and Italy, were admitted to the single currency union with public debts well in excess of the 60% of GDP limit laid down in the Maastricht Treaty. But Italy, one of the signatories of the Treaty of Rome in

1957 and one of Europe's largest economies, was deemed necessary to the economic and political success of the euro, and therefore was admitted on the assumption of future fiscal consolidation. Greece's bid for membership came during the preparations for the 2004 Olympics when massive investments had boosted economic growth. In any event, since it accounted for only about 2% of the total euro area economy, Greece was believed to be too small to have any significant impact on the stability of the monetary union.<sup>2</sup>

The other countries primarily affected by the crisis – Ireland, Portugal and Spain – were faced with interest rates set by the European Central Bank (ECB) that were inappropriate for the pace of their economic growth and their credit conditions. Loose monetary policy needed to be offset by suitable domestic policies, which did not happen. Instead credit growth and private-sector borrowing remained excessive, and current account deficits widened, signalling the build-up of large imbalances.

In the aftermath of the collapse of Lehman Brothers in September 2008 most European governments intervened to rescue their banking systems and to support economic growth. As a result public deficits and debt widened, and Ireland, Spain and Portugal ended up joining the group of countries with long-term public finance problems. For Europe as a whole the banking crisis morphed into a sovereign debt crisis.

The last two years have seen numerous attempts at the European level to address the crisis. But as well as taking effective steps to deal with the immediate problems, it is necessary to address the longer-term issues that lie at the origin of the protracted build-up of imbalances within the euro area. In addition, there are large issues about the future governance of the euro area (and of the EU as a whole) that need to be addressed if the euro is to survive.

This paper argues that structural measures to address the long-term challenges of rebalancing the euro economy, dealing with regional growth differentials and supporting GDP growth are needed for the future survival and stability of the euro. Changes to the governance of the euro are also

<sup>1</sup> For a detailed discussion on optimal currency area, see Mundell (1961, 1963, 1973a and 1973b). In addition, for a discussion on Mundell's work, the euro and optimal currency areas, see McKinnon (2000).

<sup>2</sup> Unless otherwise mentioned, all the data used in this paper are from the International Monetary Fund's *World Economic Outlook* (IMF WEO), September 2011.

needed so that countries follow policies that are consistent with the requirements of a common currency, and the burden of policy adjustment is borne more equitably.

### The critical outlook for the euro periphery

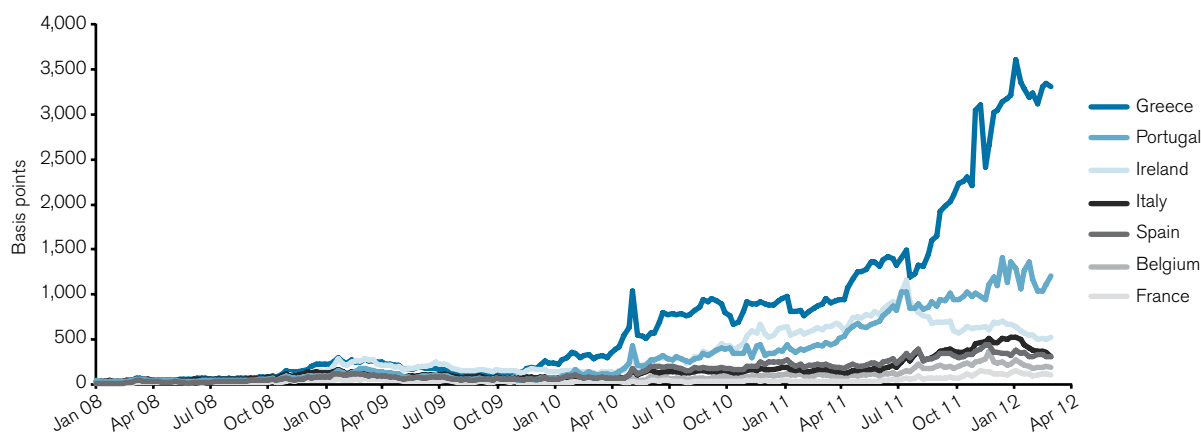
The sovereign debt crisis has widened the divide between European countries that are well adapted to survive and prosper within the monetary union and those that are not. Periphery countries with problematic debt positions saw sharp rises in government borrowing costs since the crisis erupted and at each critical point in its development (Figure 1). Before January 2010 the periphery countries were able to borrow at a similar cost to that of Germany. But by exacerbating fundamental macroeconomic imbalances and eroding market confidence the euro crisis significantly increased the risk of sovereign default within EMU, and spilled over from Greece to other countries, such as Italy and Spain, with problematic but not critical positions. Most of all, massive capital outflows from problematic countries into 'safe' countries worsened the already existing imbalances.

In recent weeks confidence has recovered somewhat, as the outlook for the world economy has improved slightly

and as the ECB's Long Term Refinancing Operation (LTRO) facility has succeeded in stabilizing markets and buying time.<sup>3</sup> The cheap loans with a maturity of three years provided by the ECB have eased the funding pressures experienced by banks in the single currency area and have contributed to the bond rally in recent months. Italy, in particular, has benefited from the LTRO and the austerity plan adopted by the new government led by Mario Monti. Bond yields have steadily declined since mid-December 2011 from their peak of 7.4% to under 5% in the first week of March 2012.<sup>4</sup>

Greece, however, continues to be the major concern despite the latest bailout package from the EU and the International Monetary Fund (IMF), and a deep 'haircut' on private holdings of Greek debt. However, structural fiscal problems remain grave. It is an open question whether Greece can implement the very tough fiscal measures required in the face of public protests and an election scheduled for April. With GDP growth estimated to contract by 3% in 2012 and rise modestly by 0.5% in 2013, there is not much scope for improvement in revenues, while a further dose of fiscal austerity is not feasible. Therefore the goal of reducing Greece's debt-to-GDP ratio to 120% by 2020 looks very ambitious and more likely unattainable.

Figure 1: The cost of government borrowing (spread over German bunds)



Note: Based on 10-year government bond yields.

Source: *Financial Times*.

<sup>3</sup> In order to support bank lending and liquidity in the euro area money market, the ECB undertook two LTROs with a maturity of three years and an option of early repayment after one year, on 21 December 2011 and 28 February 2012. Take-up by banks totalled over 1 trillion euros in the two operations.

<sup>4</sup> But it has since moved upwards, to slightly above 5%.

## The long genesis of the sovereign crisis

In the immediate aftermath of Lehman Brothers' collapse in September 2008, it seemed possible for Europe to escape the worst effects of the global financial crisis. Initially, only those European countries that were exposed through their banking and financial system, such as the United Kingdom, Ireland and Spain, were affected. Excessive credit growth in these countries, fuelled by foreign capital flows, had created imbalances that became unsustainable in the aftermath of the Lehman collapse. When the US financial and banking system clogged up, foreign capital flows were halted. Struggling parent banks cut back funding to their local subsidiaries through tightened credit or higher costs of borrowing (Subacchi 2011).

As the crisis deepened, more countries were forced to use both monetary and fiscal measures to bail out troubled banks and to support weakening economies. The banking sector was the main recipient of government and central bank money to ensure that credit flows were not frozen and thus to avoid a possible banking collapse. Troubled financial institutions were supported through capital injections, guarantees or partial nationalization. Interventions in support of the real economy were also massive,<sup>5</sup> even in countries such as Germany that were reluctant to use fiscal policy to stimulate their economies.<sup>6</sup>

Fiscal stimulus, alongside falling tax revenues and the impact of automatic stabilizers, resulted in an increase in debt-to-GDP ratios for European countries, from a pre-crisis average of around 61% to 74% in 2009. The fiscal position of some in the periphery deteriorated even more rapidly owing to a number of country-specific factors (see Table 1). These included high pre-existing levels of debt (Italy), large current spending with little scope for 'easy' cuts and efficiency gains (Greece), a rapid drop in GDP growth and consequent impact on fiscal revenues (Spain and Portugal), and large bank bailouts (Ireland). Given the pattern of public indebtedness, problems were

concentrated in euro area countries that had fast but unsustainable growth in the pre-crisis years or that had pre-existing critical fiscal positions, or both.

Table 1: Sovereign debt (% of GDP)

Euro area	2007	2011
Ireland	24.9	109.3
Finland	35.2	50.2
Spain	36.1	67.4
Netherlands	45.3	65.5
Austria	60.7	72.3
France	64.2	86.8
Germany	65.0	82.6
Portugal	68.3	106.0
Belgium	84.2	94.6
Italy	103.6	121.1
Greece	105.4	165.6
<b>International comparison</b>		
United Kingdom	43.9	80.8
United States	62.3	100.0
Japan	187.7	233.1

Source: IMF WEO, September 2011.

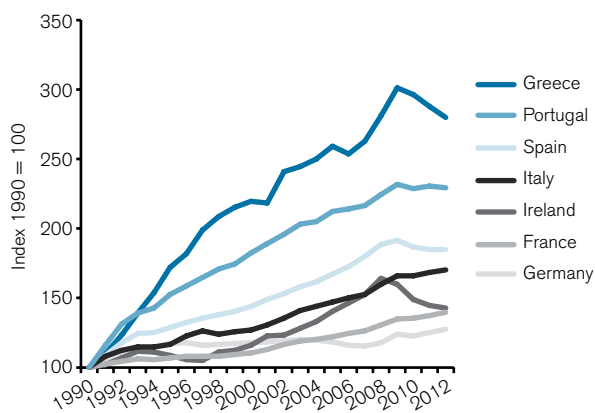
## The build-up of imbalances

Problematic fiscal positions, under-performing economies and imbalances are long-standing weaknesses of the periphery, and they all predate the global financial crisis. All countries that have been hit by the sovereign debt crisis – Greece, Ireland, Portugal, Spain and Italy – have a common problem of competitiveness, especially in terms of labour costs, which have been significantly rising since 1990 (Figure 2). Consumer prices also grew faster in the periphery countries than in Germany (Figure 3). In Ireland and Spain, this reflected strong growth and overheating economies, in particular the housing sector, supported by low interest rates at the euro area level. In Greece, Portugal and Italy high inflation was more a reflection of inefficiencies and distortions in labour and product markets.

<sup>5</sup> The size of the stimulus packages varied across Europe, from 3.8% of GDP in Spain to 0.2% of GDP in Sweden.

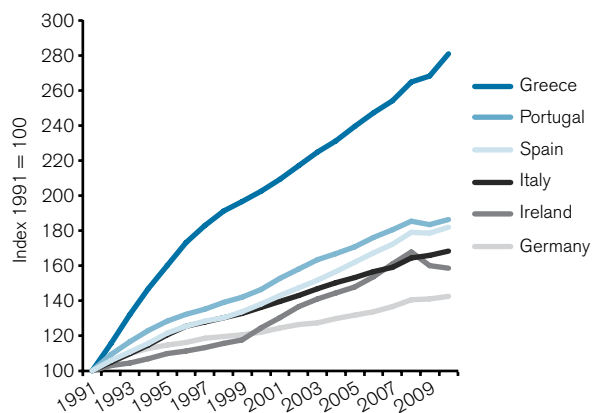
<sup>6</sup> Countries with a large export sector, such as Germany and Japan, which up to then had been almost unscathed by the financial crisis, were severely hit by a sudden and sharp drop in their exports.

Figure 2: Nominal unit labour costs



Source: AMECO, Chatham House calculation.

Figure 3: Inflation



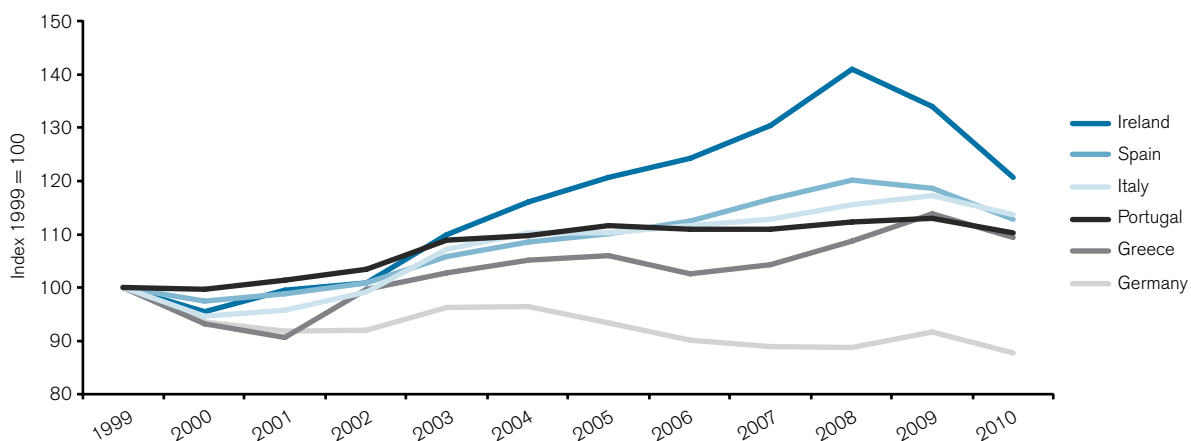
Source: OECD, Chatham House calculation.

The widening competitiveness gap between the euro periphery and Germany, and the emergence of large intra-EMU imbalances, are reflected in real exchange rates (Figure 4). Since the early 2000s Italy, Spain, Portugal, Greece and Ireland have been losing competitiveness *vis-à-vis* Germany.

These problems are also showing up in current account imbalances within the euro area. Although the euro area,

taken as a whole, ran a modest current account surplus (0.13% of its total GDP in 2011<sup>7</sup>), the figure masks large underlying imbalances across the region. Excepting Ireland, all European economies facing severe fiscal problems are running current account deficits. This is partly a reflection of the weaker export competitiveness of the euro periphery relative to the economies at the 'core', which are mostly running current account surpluses (Figure 5).

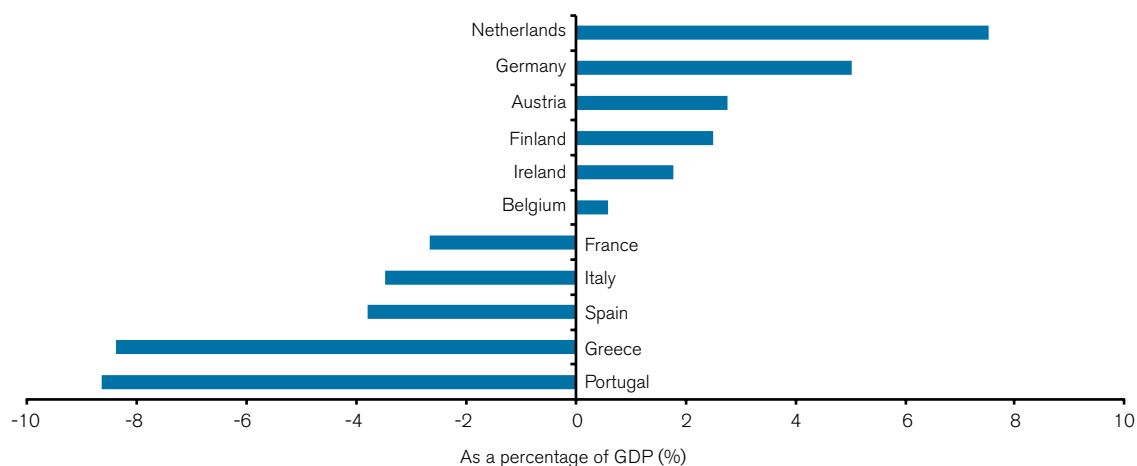
Figure 4: Real effective exchange rates



Source: Eurostat.

7 IMF WEO September 2011 estimates.

Figure 5: Current account balance (2011 estimates)



Source: IMF WEO, September 2011.

However, current account imbalances also signal problems in the capital market. Cross-border capital movements following the creation of the euro contributed to worsening current account deficits of countries – such as Ireland, Spain and Portugal – that were the recipients of large capital inflows in the pre-crisis years. On the other hand, Germany, which had experienced capital outflows, began to accumulate current account surpluses, rising from 2.8% of GDP in 2001–05 to 6.3% in 2006–10.

Even if the current account balances of the euro periphery have improved since 2008, for countries such as Greece and Portugal they are significant enough to suggest persistent imbalances that, far from being corrected by a slowdown in GDP growth – as it has been the case for the United States – indicate structural problems in attracting capital flows. These countries are no longer able to finance their external imbalances through the capital market. As a result these countries, and their banks, have relied increasingly on financing from other euro area countries, in particular from the governments, central banks and official institutions. These structural imbalances have resulted in a build-up of inter-country imbalances in the settlement system. The large increase in

Target 2 balances at the Bundesbank is yet another manifestation of the current account surpluses run by Germany.<sup>8</sup> More worryingly, the size and persistence of deficits in the periphery countries suggest longer-term structural problems in financing through capital markets (EEAG, 2012).

### A 'two-speed' Europe?

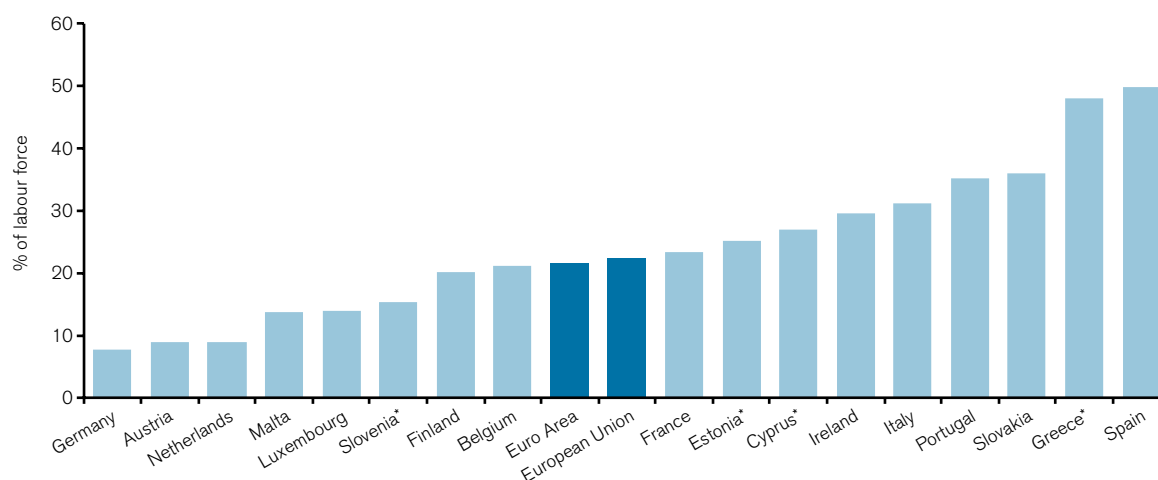
Big differences have also emerged in the growth performance of different European countries. In large part the phenomenon of a 'two-speed' Europe exposes the difference between those countries that can live within the constraints imposed by the single currency and those that cannot.<sup>9</sup> A number of countries in the periphery (in particular Greece, Portugal, Spain and Italy) are experiencing relatively low growth and high inflation, which is exacerbating their already problematic debt positions.

The growth problems of the periphery are also showing up in high unemployment rates. Again, Greece, Portugal, Spain and Italy have high and persistent unemployment, especially among the young, and with significant regional differences. Latest labour market figures show youth unemployment in Spain and Greece to be at 49.9%

<sup>8</sup> TARGET stands for Trans-European Automated Real-time Gross Settlement Express Transfer system. Target 2 is the second generation of this system, which is owned and operated by the Eurosystem – the European Central Bank and the central banks of the member states that belong to the euro area – and which offers a cross-border payment service in the European Union. For further details, see the ECB website, Payments and Markets.

<sup>9</sup> This does not necessarily imply, however, that the latter should leave EMU. Certainly they need to implement the necessary adjustments and resolve the mismatch.

Figure 6: Youth unemployment, January 2012



\*Latest available figures – Greece, Slovenia: November 2011; Cyprus, Estonia: December 2011.  
Source: Eurostat.

and 48.1% respectively (Figure 6). With German youth unemployment running at 7.8%, this again underscores the stark differences within the euro area and the practical consequences of a ‘two-speed’ Europe.

The challenges for the countries in the euro periphery are a mix of urgent priorities and long-term measures. In the immediate future they have to convince markets that their public debts are getting back onto a sustainable track, which means not only credible fiscal consolidation plans but also stronger GDP growth. They also have to normalize the access of banks to market funding and to improve their external payments position. In the longer term the challenge is to achieve sustainable increases in growth and to improve competitiveness. But none of these will be easy, in particular given the constraints of the single currency and its existing governance structure.

## Lasting solutions to the euro crisis

The euro crisis began in 2010. Since then numerous summits have been held and new institutions set up, and a new treaty has been proposed to strengthen the

oversight of national fiscal policies.<sup>10</sup> But throughout the crisis policy-makers have focused on dealing with the symptoms of the problem through a series of short-term fixes, taking decisions based primarily on political priorities and considerations. For instance, the strong resistance to the ECB acting as the lender of last resort or to issuing common bonds by the member countries primarily reflects domestic political priorities in Germany. In addition, the level of austerity imposed on the countries needing financial assistance is partly to placate the electorates in creditor countries.

The result has been a deepening of the crisis as the underlying structural problems have remained unaddressed. Not only have countries in the periphery found it increasingly difficult to finance their deficits at sustainable interest rates, but also markets are questioning the survival of the euro in its current form (Buitter 2012). Solving the crisis of the euro requires not only dealing with the immediate problems facing Greece and other troubled countries in the periphery, but also addressing these structural problems.

<sup>10</sup> Leaders agreed at their December 2011 and March 2012 summits to enhance *ex ante* fiscal surveillance and budgetary processes in the euro area. More importantly, they agreed on an intergovernmental treaty of 25 governments (excluding the UK and Czech Republic) to support recommendations the Commission makes in the framework of the Excessive Deficit Procedure, leading to greater automaticity and a balanced budget rule at constitutional or equivalent level, and to recognize the jurisdiction of the Court of Justice on these issues. Furthermore, to ensure the financial stability of the euro area, the leaders agreed that the European Stability Mechanism (ESM) should enter into force in July 2012 instead of July 2013, and that urgent decisions in the ESM can be taken by qualified majority voting.

### In the short term ... a lender of last resort

It is still essential to take short-term measures to stabilize the situation. The agreement on further financial support for Greece, together with a write-down of privately held debt, should help to stabilize the Greek economy at least over the next few months. But the prospect of elections in Greece is still worrying investors. And in the longer term it is not clear that relying on fiscal austerity to improve Greece's competitiveness is politically sustainable.

Moreover, markets are still not convinced that enough has been done to provide the resources that would constitute an effective firewall against contagion to other countries in the euro area. The European Financial Stability Facility (EFSF) and its successor institution, the European Stability Mechanism (ESM), would have sufficient financial fire-power to help Portugal if required. But the ESM would almost certainly not be able to provide the resources needed if larger economies (in particular Italy or Spain) ran into difficulties. The IMF too would need additional resources if it were to co-finance assistance packages for big euro area countries, but non-European countries are insisting that expansion of the EFSF/ESM is necessary if IMF resources are to be increased.<sup>11</sup>

The ECB has also moved decisively to provide liquidity in massive amounts and at longer maturities to ensure that European banks have sufficient liquidity to cope with the Greek debt crisis. But the ECB has also made it clear that this is not its permanent role. And the Maastricht Treaty prohibition on monetary financing prevents the ECB from acting as a fully-fledged lender of last resort to countries in crisis. Changing that provision is almost certainly impossible, not only because of the political capital invested in it, but also because in a monetary union it raises very difficult issues of burden-sharing between the member countries. This means that it is even more important to press ahead with other longer-term measures to improve the functioning of the single currency.

There are three sets of longer-term issues that need to be tackled:

- helping countries in the periphery to live within the constraints of the single currency;
- adapting the governance of the euro to provide stronger sanctions but a fairer adjustment mechanism; and
- adopting a growth model that allows the euro area as a whole and its constituent parts to grow.

### Living within the euro

Membership of the single currency means that countries no longer have control over monetary policy, one of their main policy levers. That imposes additional constraints on fiscal and structural policies to maintain competitiveness, and macroeconomic balance (both internal and external). At present the single currency also places most of the responsibility for policy adjustment on countries with current account and fiscal deficits.

To respond to the persistent loss of competitiveness in the absence of exchange-rate flexibility, countries have to rely more on fiscal policy and structural measures to achieve adjustments in relative prices and wages. At the European level, the Stability and Growth Pact (SGP) and the Lisbon process have provided frameworks to monitor and assist the necessary adjustments. In practice, though, neither has provided sufficient pressure to achieve policy adjustments at the national level. Strengthening the incentives for member countries to adjust their policies in order to maintain competitiveness is a priority.

Thought must also be given to the balance of responsibilities between deficit and surplus countries. At present almost all the responsibility is on deficit countries to cut their fiscal deficits and to apply downward pressure on wages and prices. At the aggregate level this creates a bias towards deflationary policies. In theory the ECB's monetary policy should adjust in response, with

<sup>11</sup> The meeting of G20 finance ministers and central bank governors held in late February 2012 insisted that the European nations had to build a more credible firewall before seeking help from the international community. Their Communiqué states: 'Euro area countries will reassess the strength of their support facilities in March. This will provide an essential input in our ongoing consideration to mobilize resources to the IMF.' (G20, 2012).



lower interest rates and a higher exchange rate. But there is currently little or no room for further reductions in interest rates.

‘ In order to increase the incentives for individual member countries to follow sustainable fiscal policies, the euro area must improve its surveillance of national economic policies, looking at all aspects of macroeconomic policy and performance ’

With more effective fiscal control in countries with large deficits, European policy-makers could face harder questions about the appropriate mix of macroeconomic policies at the aggregate level, including the possibility that countries with stronger fiscal positions should run more expansionary policies. The euro area as a whole is a large and relatively closed economy with substantial inter-connections between its members. Running too tight an overall fiscal policy would have adverse effects on growth, at least in the short term, especially in current conditions when other parts of the global economy are also growing only slowly.

#### Adapting to the euro

Steps have been taken to improve the governance of the euro area in respect of fiscal policy. This is essential if the single currency is to be sustained and strengthened since it needs to move towards a fiscal union as well as a monetary union.

In order to increase the incentives for individual member countries to follow sustainable fiscal policies, the euro area must improve its surveillance of national economic policies, looking at all aspects of macroeconomic policy and performance. At present the concentration of the SGP on fiscal policy reduces its ability to identify wider macroeconomic imbalances.

Stronger sanctions are also needed against member countries that do not follow sound fiscal policies. The SGP provided for fines on countries that breached fiscal guidelines. But imposition of these fines remained to be decided by the member countries, and despite clear breaches of the guidelines in 2002 and 2003 the Council decided not to take this step.<sup>12</sup>

Finally, a framework for effective dialogue and decision-making for the overall fiscal stance at the euro area level must be developed. The ECB has strong analytical capacity to understand policy-making in the area of monetary policy. The euro area needs to build an equivalent capability for fiscal policy.

However, constructing what is in effect a federal structure for fiscal policy requires a clear understanding and agreement about the boundary between decisions at the euro area level and decisions that will remain purely national. It is also likely to highlight tensions over the fiscal adjustments required in different member states. This debate has already started as Greece struggles to reduce its fiscal deficit and debt. As part of the rebalancing of responsibilities for adjustment between surplus and deficit countries within the euro area, closer integration will open up the politically difficult issue of fiscal transfers from the big surplus countries (in particular Germany) to the smaller countries running deficits. In the longer term, closer fiscal union is likely to require a permanent system of fiscal transfers.<sup>13</sup>

#### The euro as a zone for economic growth

While building a deeper currency union was intended to improve the growth prospects of all euro area

<sup>12</sup> The SGP was breached by Germany itself (together with France) in 2003, but neither country was fined. The previous year Portugal was reprimanded, but not fined, for having had a deficit of more than 3% of GDP.

<sup>13</sup> The EU as a whole does allow limited fiscal transfers through the structural and cohesion funds. But these are primarily intended to encourage convergence between the poorer and richer regions, not to compensate for the loss of monetary sovereignty.

members if they could adjust their domestic policy to the constraints of fixed exchange rates, there is a risk that it could also impart a bias against growth. Low growth makes it harder to run sound fiscal policies, and in extreme cases brings into play unsustainable debt dynamics.

The EU recognized many years ago the imperative of boosting growth. The Lisbon strategy was a response to this imperative.<sup>14</sup> But if the aim was to close the growth gap between Europe and other parts of the world, it must be seen as a failure.

Growth policies remain the objective of every government, but there is little consensus on what constitutes the growth strategy that is appropriate to the euro area as a whole. It is likely anyway to require primarily country- or region-specific measures, although there is also a role for European-wide policies to boost growth.

The experience of the last decade suggests that a good start would be to avoid European policies that are likely to damage growth. A new framework for euro area governance would be a desirable first step: avoiding a deflationary bias to fiscal policy at the aggregate level, allowing monetary policy to provide appropriate support for growth, and rebalancing the adjustment burden between deficit and surplus countries to allow periphery countries to maintain competitiveness within a single currency.

Crises, especially financial crises, tend to have a huge negative impact on growth. Setting in place a system that makes the euro area more stable and sustainable, and hence makes crises less likely, will itself make a big contribution to allowing Europe to enjoy faster growth over the longer term.

## Conclusion: the alternative

Without these changes, both to deal with the current crisis and to address some of the underlying problems that prevent the euro area from effectively coordinating its policies, it is hard to see Europe's monetary union

surviving in its current form. The costs and benefits of membership of the single currency are spread unevenly between its members, and the economic and political strains placed on individual countries by living within the constraints of the single currency are substantial.

Nevertheless, the benefits of membership of the euro are large. Members are able to trade with each other without facing currency risk, and the economic costs of currency conversion are eliminated. Many of the periphery countries have enjoyed substantially lower borrowing costs, as well as significant political benefits from membership.

Ultimately, if the cost-benefit balance tilts too far, it will lead to the break-up of the monetary union, either by forcing out some of its weaker members or by encouraging the stronger members to leave because they are not prepared to accept the consequences for themselves

Ultimately, if the cost-benefit balance tilts too far, it will lead to the break-up of the monetary union, either by forcing out some of its weaker members or by encouraging the stronger members to leave because they are not prepared to accept the consequences for themselves. But this would be a last-resort option, and would potentially reverse the trend towards greater integration at all levels within Europe. Nevertheless, unless further changes are made to the structure of the single currency to put it on a sustainable footing, it may still come to pass.

<sup>14</sup> The Lisbon strategy was adopted in March 2000 when the Heads of States met in Lisbon to set out a new strategy to make Europe more dynamic and competitive. Given the moderate results in the initial years, the focus of the strategy was narrowed to growth and jobs and it was relaunched in spring 2005.

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