# EURO UNDER CROSSFIRE. WILL THE EUROPEAN MONETARY UNION SURVIVE?

**Roxana Paraschiv**
"Alexandru Ioan Cuza" University of Iasi
roxana_paraschiv@yahoo.com

**Abstract:** *The creation of the European Monetary Union was both a political and an economic decision considered to be a success for almost a decade. Starting from 2008-2009, the EMU has been facing the most difficult moments of its existence. This paper aims at analyzing the impact of the current financial crises on the EMU member countries, the measures taken up to the present as a response to the crises and the future perspective for the European single currency. Both the breaking up of the EMU and its maintaining prove to be costly decisions. The recent evolutions have shown the political will to keep the EMU together, but we must ask ourselves at what price and risk.*

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## INTRODUCTION

Officially launched on the first of January 1999, the European single currency was an important step forward in the European integration process. This important political and economical decision had behind strong debates regarding its opportunity and viability. For its critics, the European Monetary Union (EMU) was too big to become an Optimal Currency Area (OCA) and the criteria concerning an OCA were not fulfilled.

Despite the scepticism regarding its creation, the economic performances of the EMU up to 2007 were favourable: an average growth rate of 2.18%, comparable with the previous decades, increased employment and trade, monetary stability. In addition we may also speak about the well knows advantages of a single currency – reducing the transaction costs and exchange rate risks, increasing price transparency and competition, better perspectives especially for small and open economies regarding their trade activities, increased potential for economic and financial stability and so on.

Even with this favorable evolution the Euro Area is facing today one of the most difficult moments of its existence. The financial crisis that hit the world economy in 2007 has affected even more dramatic the European Union as it combines the debt problems with the competitiveness gap and heterogeneity. The single currency was designed to (among others) increase the performances of the European economy, but it became today a source of turbulences and disagreement that strongly affect the EMU member countries.

## 1. THE IMPACT OF THE CRISIS ON THE EMU AND THE MEASURES TAKEN IN ORDER TO HELP THE MEMBER STATES

The crisis hit the European economy after a period of relative stability and growth. Greece, for example, had an average growth rate of 4.2% during 2000-2007. Unfortunately, for some countries, this favorable period was hiding the accumulation of important disequilibria such as large public deficits.

In order to support the economic growth affected by the crisis, governments adopted extraordinary expansionary macroeconomic policies – the interest rate was reduced in order to lower the borrowing costs, the central banks provided liquidity to compensate the problems of the banking system, fiscal stimulus were offered. All these led to huge budget deficits, more than twice than it has been predicted (European Commission, 2009).

It is not easy to say weather these measures were opportune or not, but it its obvious that they did not solve the problems. Crisis times demand for urgent measures, usually short time oriented, but the European economy urges for structural long term reforms in order to increase aggregate demand and household income on the short run and growth and employment on the long run.

These measures transformed the global financial crisis into a government deficit crisis and then into a sovereign debt crisis for the Euro Area, affecting many countries, especially (but not only) Greece, Ireland, Italy, Portugal, Spain (the so-called "PIIGS").

The rating agencies penalized the countries confronted with big government deficits and this led to a lack of confidence of the financial markets. Greece was the first country seriously threatened by the sovereign default risk. Legally, the European Central Bank was not responsible for rescuing Greece or other countries in a similar situation. In fact, in the beginning, the ECB officials stated that they would not change the rules for one country's sake. But the dramatic evolution of the events determined the ECB and the EU to support countries in difficulty in order to save euro. A rescue package of 110 billion euros was agreed for Greece (later supplemented by 109 billion euros), an 85 billion one for Ireland and 78 billion for Portugal, but the problems are far from being solved yet. Greece's debt burden has become unsustainable, as the government debt exceeds the country's annual output and the interest rate for government credits is around 6.5%.

Another measure for helping the most affected countries was the creation of the European Financial Stability Facility (EFSF) in May 2010. EFSF helps the countries in need by buying bonds of the heavily indebted countries at a lower borrowing cost. Up to the present Greece, Portugal and

Ireland used this facility and it is possible for Italy and Spain to do it too in the future.

On the 27th of October 2011, the European leaders and the representative of the international finance agreed on a set of measures in order to save Greece of the imminent sovereign default and also the other European economies affected by the debt crises. Despite the fact that the Greek economy is only 2.5% of that of the EMU, a sovereign default would have certainly affected the entire Union and especially the countries confronted with similar problems – Portugal, Ireland, Spain. The most important measure was the reduction of Greece's debt burden by 50%, representing 100 billion euros. The remaining 100 billion will be guaranteed by EFSF up to 30 billion euros. The bailout package of 109 billion euros agreed in July 2011 was increased at 130 billion and the EFSF increased from 440 billion euros to 1000 billion. Jose Manuel Barosso, the president of the European Commission, affirmed that these were exceptional measures for exceptional times and Europe should never find itself into this situation again.

Another important measure is the recapitalization of the European banks affected by the sovereign debt crisis. The banking system needed this recapitalization because it has been strongly affected by the Greek debt cut, as many European (and especially French) banks invested in Greek bonds. Initially Germany did not agree with de debts cut, considering that the sharing of the debts cost is a mean of rewarding the irresponsible governments, leading to moral hazard. In addition, saving countries with large deficits is also forbidden by the Maastricht Treaty. On the other hand, France, strongly affected by the Greek debt crisis insisted that the entire euro area participate to the bailout plan.

The measures adopted during this summit seem like oxygen to the Greek economy, but, in reality, they are not solving the problems, but only postpone a tragic end. In addition, it is not known yet how these measures would be effectively financed and where would the money come from. Increasing EFSF with the help of investment funds from other countries (China, Singapore, Arabian countries) is not a completely un-risky option.

Recently, during the December European Council, it has been agreed on several reforms for solving the euro debt crisis, including a stronger control over the national budgets and sanctions for the member countries that are not meeting the criteria regarding the budgetary deficits. The reactions of the financial markets to these new measures were confused, proving that the uncertainties still persist. The UK refuse to accept the change of the EU Treaty created a negative reaction and grew the already existing pessimism.

## 2. WHAT FUTURE FOR THE EUROPEAN SINGLE CURRENCY?

There are two points of view regarding the EMU during this economic crisis. On the one hand, there is the opinion that the single currency protects the member states against global turbulences and provides the necessary help for the countries in need. That justifies the desire of other new countries to enter Euro Area (Slovakia adopted euro in 2009, Estonia in 2011 and other countries are preparing for it). On the other hand, the crisis has shown that the competitiveness gap and heterogeneity of the member states create huge economic difficulties. The heterogeneity regarding employment or wage and labor dynamics are not only the result of the crisis, but rather the result of the structural differences among he member states in terms of revenue, employment structure (part time and full time), labor market conditions before the crisis, the financial situation of the firms etc.

It is interesting to notice that while the theoretical debates about the euro stressed the real convergence of the member states (in terms of factors' mobility, the flexibility of wages and prices, the openness of the economy and production diversification), taking into account the danger of the asymmetric shocks caused by structural differences, the Maastricht criteria targeted the nominal convergence in terms of inflation, interest rate and public finance. In addition, Greece was proved to have cheated statistics regarding the public debt and the government deficit, meaning that it has probably never been prepared to adopt euro. Looking back through the eyes of the recent developments, one could notice that EMU was in the first place a political project that ignored the economic gap among the member states, because the EU leaders did not want to separate the Union into two groups – core and periphery – as suggested by the theoretical and empirical studies. EU probably bears now the consequences of such an approach, not talking about the fact that even the nominal criteria were not met. Taking into account the theoretical criteria of the optimal currency area, only Germany, France, Belgium, Netherlands, Luxembourg and Austria would have qualified for the EMU in the first place and the periphery (Italy, Spain, Greece, Portugal and Ireland) would have been let outside – certainly with less dramatic consequences than the breaking of the EMU.

The breaking of the Monetary Union would be a strong blow for the European Union, for its credibility and competitiveness. Nevertheless, there are voices suggesting that this would be a good decision for the European economy and for the European citizens. Professor Philipp Bagus suggests that the European single currency is a mean of centralising the European economy and that an integration process based only on the four freedoms would be far more helpful for the economy

(Bagus, 2011b). This idea is today hard to be combated taking into account that the stronger intervention in the Euro Area economy does not seem efficient in solving the problems, but more in postponing their effects.

The analysts are taking into account different scenarios for the future of the EMU. A first scenario is maintaining the Euro Area with its current member states. As we said earlier, the breaking up would make the EU situation very complicate. But the costs of preserving euro seem also very high. We think, first of all, about the costs involved in the bailout plan that implies an inflationary perspective for the future. Secondly, we think about the long term perspective, where a political union would be necessary in order to prevent other uncontrolled government deficits. Although this could be seen as a great accomplishment for the European integration process, it is important to seriously consider its consequences in terms of loosing the national sovereignty and the existence of a huge supra-national structure coordinating 27 or more very different member states. A political union would be indeed beneficial for the single currency but very costly for the European citizens and nations. In addition, we must take into account that the common fiscal policy implemented inside the political union does not necessary mean the end of all problems, since it would not be implemented only by Germany, with a strong fiscal discipline, but also by other countries less fiscally responsible, but more numerous.

A major problem for the EMU is that the most productive and disciplined countries have to pay for the most unproductive and wasteful ones. Even if the current crisis was regarded as an extraordinary situation demanding for extraordinary measures, if this process goes on, the already affected population will not accept it any longer. And even if they did, this would still be a loss of economic efficiency. Professor Philipp Bagus resumes this by saying that "irresponsible governments benefit at the cost of more responsible governments." (Bagus, 2011a). The Germans, for example, are not willing to pay for the Greek welfare state and there are voices denouncing the Greek social contract that involves buying the social peace through public sector jobs, pensions and other social benefits.

Another possible scenario is the breaking up of the EMU.

If Greece leaves the monetary union, the short term consequences would be dramatic. This would be an extremely costly option as it would lead to increased debt burden and to the run of the national deponents, willing to protect their savings of the imminent depreciation of the national currency.

Another possibility would be for Germany to leave the euro area and start a new union with

countries that have a positive current account balance – Netherlands, Austria, Finland, Luxembourg, Denmark, Sweden, Switzerland and the Baltic countries. Such a monetary union would be the world largest creditor, bigger than China. The remaining countries could eventually form another monetary union, targeting job protection rather than low inflation.

At any rate, the Maastricht Treaty does not refer to the possibility to exit the monetary union. This opens the possibility to speculate – some analysts even consider that leaving EMU would be illegal or that a country that leaves EMU should also leave EU. Anyway, if a country decides to leave EMU, the technical problems would probably be the less serious among all the other consequences. We must not forget that the Maastricht Treaty has already been violated by the bailout plan.

France and Germany proposed in February 2011 a pact for competitiveness in order to reduce and even eliminate the differences that weakened the Euro Area. The proposed measures imply constitutional limitation of public debts (accepted during the December European Council), increasing the retirement age, elimination of the wage indexing with inflation. Even if some countries are reluctant to apply such measures, the surviving of the Euro Area is conditioned by the structural economic reform as the present criteria for the EMU seem not enough to allow its good functioning.

## CONCLUSIONS

There are in our opinion two issues of major concern for the EU during the current crisis – one is the rapid increase of public indebtedness affecting not only the internal stability of a country, but also the stability of the entire Union, and the other is the decline of potential growth, with all its consequences – low investment, low employment, low R&D expenditures, huge budgetary deficits and so on.

The turbulences affecting the Euro Area represent a major thread for the EU. The European leaders seem willing to do all that it takes to save the Monetary Union and the members that are the most affected by the crisis are neither interested in giving up euro. The breaking up of the monetary union would have hard to estimate consequences on the European economy. Since no one from inside is really interested in the breaking up there is only one problem left – the effective ability of the member states to surpass this crisis.

Although the question on everybody's lips is whether the EMU will survive this crisis, in our opinion that is not the most important issue. EMU might survive as a result of a political decision to strongly support it, but the real question is at what price and risk. The internal competitiveness gap will not disappear with this crisis and this gap has the potential to create other disequilibrium in the future. Overwhelming these disequilibria implies huge financial transfers from the core to the periphery. As long as these transfers are not use for investment and economic developments they only mean loss of welfare for donors with no effective results for the receivers.

The current economic crisis might also change the face of the European Union, transforming it into a more powerful supra-national institution that would receive a great part of the member states sovereignty. We have to seriously ask ourselves if we want such an evolution and if we are aware of its consequences. We are speaking today more and more about the disappearance of the borders, thinking that this implies more freedom, but decisions taken far away from us could mean, in fact, less freedom.

We do not doubt about the political will to keep the Union working. Although very important, this is not enough. The economic disparities among the member countries are, in our opinion, bigger than the capacity of the wealth economies to contribute for their reduction. On the other hand the European Union and particularly the EMU cannot properly work with such disparities and especially the economic crises are very difficult to surpass. The European economy needs serious structural reforms, painful for many of its citizens and therefore long postponed by the leaders. In addition, the solutions that have worked in one part of Europe are inefficient in others because of the different economic systems and cultural values. That is the reason why we cannot share a strong optimism about the future of the European Monetary Union and even (or consequently) of the entire European integration process in its current form.

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