CHALLENGES OF THE ECONOMIC AND MONETARY UNION IN THE CONTEXT OF THE ECONOMIC CRISIS

Ioana Laura **Văleanu**
Alexandru Ioan Cuza of Iași, România
Ioanalaura1@yahoo.com

Abstract: *The economic and financial crisis which has affected the world economy since 2008 raised a question mark regarding the viability of the Economic and Monetary Union and the future of the euro. The main objective of this paper is to identify the amplitude of the effects of the economic crisis on the functioning and stability of EMU. Following the main objective, the study is meant to analyze the theoretic fundamentals which were at the basis of the creation of EMU and an analysis of the financial policies and instruments meant to render stability and sustainable economic growth in the countries of the Eurozone.*

Keywords: Economic and Monetary Union, Optimum Currency Areas, euro zone, economic crisis, stabilization policies
JEL Classification: E62, H63, G01

INTRODUCTION

The global financial crisis which started in September 2008 and was followed by the most serious economic recession of the last decades has determined the design and implementation, at the level of governments, of vast ranges of emergency measures for the stabilization of the financial sector and for the amortization of the negative effects on the national economies. The effects of global economic crisis as perceived also in the European economies seem to have an important impact on the functioning of the Eurozone. This new financial and economic context determined the debate and reinterpretation of problems and questions, which refer to the functioning norms of the Eurozone, the efficiency of a monetary union which contains countries with different development levels and in the absence of a fiscal cohesion, the opportunity of a new extension of the Eurozone or even the future of EMU.

But the economic crisis is not the only one to blame for the current situation of the Eurozone, as causes can be found also in the asymmetrical nature of the monetary union. Criteria of OCA have not been fully fulfilled by the Member States of EMU neither when the monetary union was created nor now.

At present the fundamental problems faced by the countries of the Eurozone are the high unemployment levels, internal commercial disequilibria, lack of economic growth, alarming quotas of the budgetary deficit and of the public debt.

1. FUNDAMENTALS OF THE MONETARY UNION THEORY

The problem of the economic integration and of the effects of the liberalization of the commerce has been the debate topic of economists ever since Adam Smith's. The economic integration materialized through a Monetary Union, with the unique currency and monetary policy was initially perceived as a source of benefits for the economies of the member States. In short, the economic integration represents a way of progress through the elimination of barriers in commerce (trade integration), the free circulation of production factors (factor integration), the harmonization of national economic policies (policy integration) and the unification of these policies (Balassa, 1961). Among the most important benefits of the creation of a monetary union a mention should be made of the elimination of the exchange rate costs, the stability of prices and of the employment level, the increase of the real GDP, the diminution of risks in the economic relations between the Member States. Still, a monetary union also involves that the Member States give up their own monetary policies, most frequently used as a stabilization instrument of an economy. Thus, in the case of economic shocks, the equilibrium can be reestablished by adjusting the market mechanisms and by using fiscal policies. The economic integration should promote the convergence between the participating countries, so that the mechanisms of economic adjusting should be efficient and produce uniform effects. In this situation it is absolutely necessary that the Member States of a monetary union should fulfill a series of conditions, such as: the high degree of mobility of manpower and of capital, the diversified production, the opening of economies and the mobility of prices, salaries and the market (Mundell, 1961). In addition, for the elimination of the possible weak points of a monetary union it is necessary that the countries forming this union should have a similar economic development, comparable values of macroeconomic variables such as the GDP per capita, the budgetary deficit, the public debt in relation to GDP, the interest rate. Authors such as Obstfeld (1998) or Frankel and Rose (1997) grant a special importance to the degree of synchronization of the economic cycles and of economic shocks in the economies of the Member States. The problem of the synchronization of the economic cycle is extremely important within an economic and monetary union, as it is on this that depends, to a great extent, the success of an economic policy of adjusting the economies of the Member States. In the case of economies with a low synchronization level of the economic cycle and affected by asymmetric economic shocks any monetary policy stipulated by the supra-national bank for the stabilization of the economic situation shall produce unequal effects or even contrary ones. Therefore, the fulfillment of the above criteria

by the countries forming a joint monetary zone represents an essential condition for the efficient functioning of stabilizing economic mechanisms meant to absorb economic shocks.

Based on the OCA theory, one can conclude that countries considerably different, both regarding their development level and the economic mechanisms, should be subjected to a real convergence process before forming a monetary union. This real convergence process involves radical institutional and structural changes.

Benefits which the countries of the monetary union can obtain, both in the short and in the long run, are considerable. But these benefits can also be accompanied by costs materialized in the loss of economy stabilization instruments. Both advantages and costs depend on a series of factors (Bukowski, 2011):

1) *The economy opening degree*: the more open an economy is the higher the advantages from the adhesion to a monetary union;

2) *The international mobility of production factors:* the high manpower mobility facilitates the adaptation to the negative effects of the asymmetric economic shocks and reduces the pressure on the exchange rate adjustment;

3) *The symmetry of economic shocks and the economic cycle synchronization:* asymmetric shocks and the economic cycle un-synchronization require economic adjustment policies specific to each country, fact which is though impossible within a monetary union;

4) *The diversified production:* a country which exports a very diversified series of products shall be less vulnerable to production sector specific shocks;

5) *Fiscal transfers:* neutralizes the effects of asymmetric shocks in a monetary zone.

6) *The fiscal policy integration degree and the similitudes of inflation rates:* the differences between the inflation rates lead to a loss of the competitiveness for the countries with high inflation rates.

Debates regarding the effects caused by the adoption of the unique euro currency brought in discussion the theory of endogenous effects of monetary integration. Authors such as Frankel & Rose (1997) or de Grauwe (2006) identify four zones in which endogenous effects for the new Member States can take place:

a) Commercial integration;

b) Shock symmetry;

c) Manpower and production flexibility;

d) Financial integration or integration of the insurance systems quoted by the capital markets.

By the endogeneity of the OCA criteria, Frankel & Rose (1997) claim that although when the monetary union was created the participating economies do not fulfill the conditions imposed by OCA, it is precisely the creation of such a union that shall create the favorable economic context for the later fulfillment of such conditions. De Grauwe (2006) identifies three mechanisms through which the OCA criteria explain endogeneity. First of all, the monetary union can influence the commercial flows and sustain commercial integration, thus increasing the benefits of monetary union. Monetary integration can also lead to an intensive financial integration, facilitating the occurrence of insurance mechanisms. Third, a monetary union lead to the increase of manpower flexibility, thus reducing adaptation costs to the asymmetric shocks within the monetary union.

In spite of the arguments given by the hypothesis of endogeneity of the OCA criteria, deep structural and institutional changes seem absolutely necessary when the economies of the countries composing the monetary union are characterized by the inflexible markets, high inflation rates and high quotas of the budgetary deficits and of public debt. And in the case of countries with different economic development levels a real convergence process becomes necessary in order to assure the stability of a monetary union.

Another important problem which the creation and optimal functioning of a monetary union raises is the one of fiscal federalism. In this regard, one should ask whether a monetary union would not operate better through the transfer of fiscal policy competences from the national level to the supranational one. Certain authors sustain the idea of fiscal federalism, considering it a source of stability for a monetary union (McKinnon, 2002).

2. FINANCIAL CRISIS AND THE CURRENT IMBALANCES IN THE EURO AREA

The global financial and economic crisis has revealed deficiencies and structural problems of certain countries of the Economic and Monetary Union (EMU). Economic and financial turbulences of the last years have cast a new light on the amplitude and less wanted effects of the world economy interdependences. This new economic and financial context seems to point out certain economic and structural deficiencies of the very Economic and Monetary Union.

Due to a prolonged integration process, the EMU countries have developed substantial institutional and systemic similitudes. The EMU countries have only preserved the control over fiscal policies, which were anyway restricted by SGP and other EU specific fiscal norms. Lacking instruments of monetary policy and the limitations imposed on national fiscal policies also diminish

considerably the impact which an EMU Member State may have on the course of the own economy.

In 2007, before the global economic crisis started, EU and the Eurozone reached the maximal level of the last decades, this due to the general favorable economic conditions. The global financial crisis influenced the economic activity of the EU countries through the transmission channels such as the connectivity of the financial system and the interconnections within the international commerce. With more than 4% decrease of the real GDP in 2009 both in UE and in the Eurozone, recession has proved to be the highest after World War II. Except Germany, economic comeback in the Eurozone has remained slow. Although in the first quarter of 2010 moderate economic increases have been registered, the current numbers show that the Eurozone and the EU are still far from the economic performances before the crisis.

Although the Eurozone economies are still different in terms of human capital, the social capital and the production capital, natural resources and solutions adopted at the institutional level. To these differences we should add the variations pertaining to traditions, experiences, corporatist culture, and the law compliance degree, through which the EMU countries create varied business environments or different innovation absorption capacities (Kowalski, 2012). All these differences are reflected in the level of competitiveness of each country and influence the way each of these countries has reacted to economic and financial disturbances initiated by the global economic crisis.

The debt crisis in the PIIGS countries (Portugal, Irland, Italy, Greece and Spain) seems to be not only a debt crisis, but rather a competitiveness and growth crisis, that created structural imbalances in the Eurozone. The lack of growth in the euro area periphery over the past years has been due to an erosion of competitiveness (Volz, 2012). In the peripheral countries the economic growth was a result of capital inflows and low real interest rates. This situation led to large wage increases in excess of labor productivity growth, higher price inflation and higher unit labor costs than in other core countries of the euro area (for example Germany, which used the waged constraints and the structural reforms to improve the price competitiveness). Concluding, there are large competitiveness differences between *core* and *peripheral* Eurozone countries and these differences amplify the imbalances in the EMU.

Nowadays more of the problems the Eurozone is faced with are due to the high level of public debt and the governmental deficits of certain EMU countries. From this point of view the worst situation is found in Greece, Ireland and Portugal, countries which were forced to borrow money from other governments of the Eurozone or from FMI in order to avoid the payment incapacity of

the debts. Still, even with such financial assistance, Greece had to restructure its debts, fact which led to substantial losses for private creditors.

The situation is not better in Italy and Spain either, whose public debt has reached alarming levels (the debt of Italy is higher than the cumulated debts of Greece, Ireland, Portugal and Spain). The economic and financial context of Italy and Spain has determined investors to request higher interest rates for purchasing and holding obligations in these countries.

In 2007 the criteria of the deficit of public financial sector was fulfilled by 10 of the 12 EMU countries, 6 out of 10 registering a budgetary surplus (the greatest percentage being the one of Finland and Luxemburg, with 5.2% and 3.7% respectively). The financial and economic crisis of 2008-2009 affected differently the general government financial balances (GGFB) of the EMU countries. During the 2009-2010 period when recession reached its peek, most of the EMU countries have registered deficits, only Finland and Luxemburg exceeding the level of 3%. The most serious fall of GGFB took place in Ireland (32.4%), Greece (15.6%), Spain (11.1), Portugal (10.9%) and France (7.5%).

Often, the main culprit for European debt crisis was found in the large government spending with social security systems. But, the Nordic countries Finland, Norway, Denmark and Sweden demonstrate the opposite. Although these countries have the most generous social security systems in Europe, they have relatively low debt-to-GDP ratios and are not affected by the crisis. The European debt crisis is due to the response of the euro area governments with counter-cyclical fiscal policies to the falls in output that increased the fiscal deficits. Also, the causes of the European debt crises consist in the rising unemployment and in the government bailouts of banking systems.

Table 1 – Government budget balance and debt ratios in the euro area

	Budget balance					Debt				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Belgium	-0.2	-1.2	-5.9	-5.8	-5.8	84.2	89.8	97.2	101.2	104.0
Germany	0.2	0.0	-3.4	-5.0	-4.6	65.0	65.9	73.1	76.7	79.7
Ireland	0.3	-7.2	-12.5	-14.7	-14.7	25.1	44.1	65.8	82.9	96.2
Greece	-3.7	-7.7	-12.7	-12.2	-12.8	95.6	99.2	112.6	124.9	135.4
Spain	1.9	-4.1	-11.2	-10.1	-9.3	36.1	39.7	54.3	66.3	74.0
France	-2.7	-3.4	-8.3	-8.2	-7.7	63.8	67.4	76.1	82.5	87.6
Italy	-1.5	-2.7	-5.3	-5.3	-5.1	103.5	105.8	114.6	116.7	117.8
Cyprus	3.4	0.9	-3.5	-5.7	-5.9	58.3	48.4	53.2	58.6	63.4
Luxembourg	3.7	2.5	-2.2	-4.2	-4.2	6.6	13.5	15.0	16.4	17.7
Malta	-2.2	-4.7	-4.5	-4.4	-4.3	62.0	63.8	68.5	70.9	72.5
Netherlands	0.2	0.7	-4.7	-6.1	-5.6	45.5	58.2	59.8	65.6	69.7
Austria	-0.6	-0.4	-4.3	-5.5	-5.3	59.5	62.6	69.1	73.9	77.0
Portugal	-2.6	-2.7	-8.0	-8.0	-8.7	63.6	66.3	77.4	84.6	91.1
Slovenia	0.0	-1.8	-6.3	-7.0	-6.9	23.3	22.5	35.1	42.8	48.2
Slovakia	-1.9	-2.3	-6.3	-6.0	-5.5	29.3	27.7	34.6	39.2	42.7
Finland	5.2	4.5	-2.8	-4.5	-4.3	35.2	34.1	41.3	47.4	52.7
Euro area	-0.6	-2.0	-6.4	-6.9	-6.5	66.0	69.3	78.2	84.0	88.2

Source: European Comission

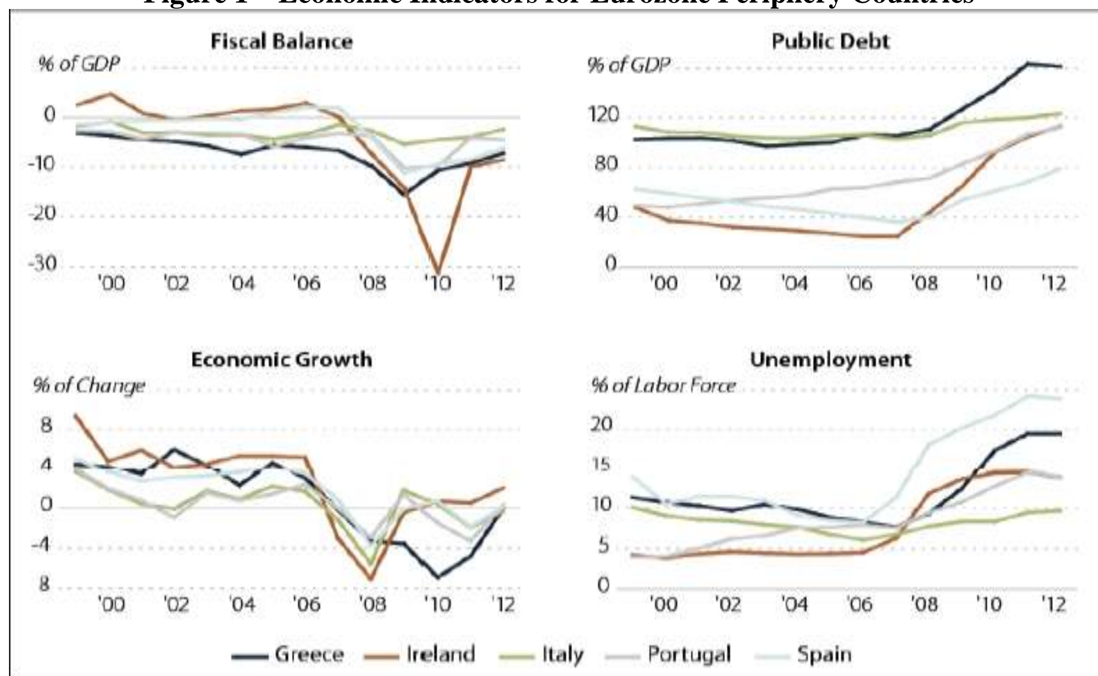
The complete or quasi absence of an economic increase in the Eurozone countries makes impossible the reduction of their public debt. IMF estimated that the Eurozone economy shall contract with 0.3%, while in 2013 a modest economic growth shall take place. For certain Eurozone countries, respectively Greece and Spain, this prognosis seems to be an optimistic one, while their economic situation is much more serious. For Greece, it has been estimated that the economy contraction during 2007 – 2012 would be of almost 20%. For Ireland prognoses estimate a fragile economic increase of only 0.5% until the end of year 2012.

Another problem EMU is facing is represented by the banking system of this area. Many banks of the Eurozone hold periphery bonds and many analysts consider these do not have enough capital to absorb losses from holding sovereign bonds, reason why many governments in the Eurozone should restructure their public debts. Certain banks of the Eurozone report difficulties in borrowing from private capital markets, determining investors to fear a banking crisis in Europe, with worldwide repercussions.

Persistent commercial deficits sometimes turn the situation of EMU countries much more difficult, becoming impossible to neutralize the economic recession effects through an export-based increase. Although certain countries have adopted measures aiming at the liberalization of the rigid manpower market to create a plus of competitiveness for their economies and for sustaining exports, it seems that their effects shall be effective in the long-run.

In most of the Eurozone countries the unemployment rate increased, but in the Eurozone periphery (PIIGS countries) it has reached alarming levels. The highest values of unemployment are found in Spain and Greece (24.2% Spain, 19.3% Greece).

Figure 1 – Economic Indicators for Eurozone Periphery Countries



Source: International Monetary Fund, *World Economic Outlook*, 2012

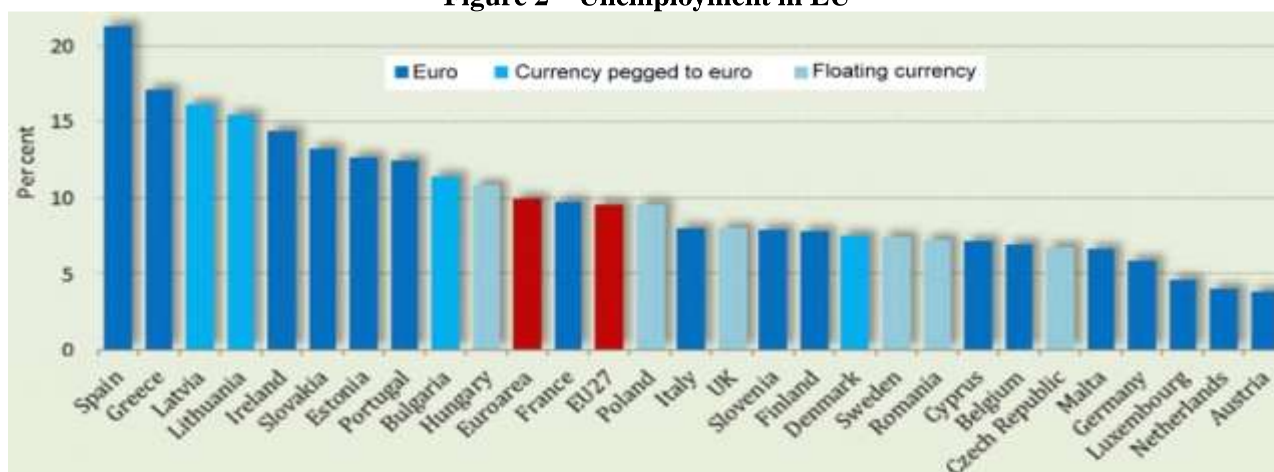
The global economic and financial crisis also led to debates regarding the structural problems EMU is facing. Certain economists consider a weak point of EMU, which can affect its economic stability, the lack of a fiscal union which would foresee a centralized budget and a fiscal transfer system between the Member States. The possible advantages of a fiscal union would consist in the possibility of a central fiscal authority to control expenses in the EMU Member States and use fiscal transfers for the absorption of asymmetric economic shocks which would affect the Eurozone.

The trade volume in the Eurozone decreased dramatically in the last quarter of 2009, as a result of the decrease of the demand for long-term goods and of the enterprise investments. Commerce has been affected by the demand shocks at the level of the capital and of the sustainable items. Governments acted so to support the aggregate request and the financial sector. But effects have not been the expected ones because the fiscal situation in the Eurozone has acknowledged a continuous deterioration reflected in the public finances and the budgetary deficits, which increased from only 0.7% of GDP at the end of 2007 to 6.2% of GDP at the end of 2010. In the first half of

2011 the Eurozone deficit acknowledged a poor amelioration and decreased in the 2 quarter to 5.5%.

While the crisis of sovereign debts continued to affect the real economy, many European countries would face very high unemployment levels, fact due to a certain extent to the imposed financial austerity and the reduction of governmental expenses. Spain is still fighting for exceeding its dependence on the construction sector which assured its years of economic growth and helped it keep an acceptable budgetary deficit until the financial crisis started. On the basis of statistic data one can notice that EU Member States with the highest unemployment rates are those in the Eurozone and those with euro-referred currencies in comparison to the countries having floating national currencies.

Figure 2 – Unemployment in EU



Source: Eurostat

3. EUROZONE STABILIZATION POLICIES

For solving the problem of the sovereign debt two types of measures have been implemented: austerity measures and salvage plans. Austerity applies nationwide through the reduction of governmental expenses to limit the current and future budgetary deficit to increase the confidence in markets and to maintain interest rates at a low level. Still, in several countries' case, austerity has not proved to be the best solution. Although Greece has reduced its budgetary deficit with more than 5% of GDP, during the period 2010-2011, its economy contracted with 10%. The austerity measure raises efficiency problems and through the fact that it may lead to a stabilization through recession and imposes huge costs for the population. Financial austerity provides few perspectives of sustained growth in the future, proving to be a measure with rather short term effects.

Regarding the salvage plans, following the intensification of the financial crisis at the beginning of year 2010, the EU became aware of the necessity of a consensus regarding the solving of the problem of public debts in the Eurozone and the possibility that this problem would extend also to other EU member states. In May 2010, finance ministers in the EU agreed to adopt a 110 billion euros budget for saving Greece from economic collapse and for stopping the dissemination of the crisis to other peripheral economies. This salvage package also imposed a series of measures of austerity which received violent criticism.

The adoption of the European Financial Stability Facility (EFSF), in June 2010 received a positive feedback on the financial markets, but it had a limited impact on the real economic indicators. The EFSF was initially created for selling bonds and using the funds for providing loans of up to 440 billion euros to the Eurozone countries facing difficulties (through the European Financial Stabilization Mechanism – EFSM). For the year 2013 it is foreseen that EFSF and EFSM shall merge in a single permanent rescue funding programme. The European Financial Stabilization Mechanism (EFSM) shows that the answer to the Eurozone crisis is represented by the reaching of the long-term stability purpose. EFSM shall stipulate tougher penalties and shall be used for fighting financial contagion between EU countries in case one of the countries would be in the payment incapacity.

From the monetary point of view, the Central European Bank (CEB) took a series of measures meant to reduce of the volatility on the financial markets and for the assurance of the liquidities for funds allocations for the Long Term Refinancing Operations (LTROs).

Analyzing certain aspects of financial crisis in the Eurozone could be due to a certain extent to the violation of certain clauses of the EU treaties such as the no bail-out clause, the violation of the convergence criteria, the insufficient protection of the tax payer, the exceeding of the budgetary deficit, which normally should not go beyond 3% of the GDP, and the raw public debt beyond 60% of the GDP. For Eurozone members there is the Stability and Growth Pact (SGP) which also refers to the limitation of the budgetary deficit and of the public debt but also involves a much stricter financial regime.

Beyond the measures taken at the structural level for fighting the effects of the economic crisis in the Eurozone, certain economists also claim the necessity of institutional changes, which would consist in the completion of the monetary union by a fiscal and financial union (Shambaugh, 2012). Still, an impediment in the creation of a fiscal union may be the fact that EMU Member States do not have the same development level, situation which would rather require the creation of an institutional framework that shall allow a multi speed Europe, than the total convergence target.

An extreme measure for providing a solution to the Eurozone crisis would be the exiting of this union of the peripheral economies. This is though rather improbable given the huge costs it involves. Such a situation would turn many countries in the Eurozone insolvable. Taking into account the debt of such countries is found in the balances of banks and insurance companies throughout the world, the financial instability effects could be disseminated through the financial system.

CONCLUSIONS

The European crisis has revealed potential vulnerabilities of regional financial and monetary integration. One of the major causes of the current economic situation in the euro area was that monetary unification was not accompanied by an adequate level of financial and macroeconomic convergence among euro area countries. Nonetheless, it would be a mistake to minimize the positive effects of the European Monetary Unification. The Euro area countries most affected by the economic crisis have been PIIGS or Eurozone periphery countries (Portugal, Ireland, Italy, Greece, and Spain). Perhaps if these countries carried out structural reforms and adjusted internally in time, they would not face the current problems. The debt crisis in the PIIGS countries (Portugal, Irland, Italy, Greece and Spain) seems to be not only a debt crisis, but rather a competitiveness and growth crisis, that created structural imbalances in the Eurozone.

The vulnerabilities of the euro area and its member countries have become obvious now and they should be addressed. Despite all critics, European policymakers have responded to the crisis with extensive reforms of the euro area's institutional framework as well as specific structural reforms for member countries.

REFERENCES

Balassa, B. (1961) *The Theory of Economic Integration*, Homewood, IL, pp.153.

Bukowski, S.I. (2011) *Economic and Monetary Union – Current Fiscal Disturbances and the Future*, International Advances in Economic Research, Vol. 17, Issue 3, pp 274-287 accessed on June 2012 at http://link.springer.com/article/10.1007%2Fs11294-011-9310-7?LI=true.

de Grauwe, P. (2006) *What Have we Learnt about Monetary Integration since the Maastricht Treaty?*, JCMS, Vol. 44, No. 4, pp. 711–30 accessed on July 2012 at http://www.intertic.org/Unions%20Papers/Degrauwe3.pdf.

Frankel, J.A., Rose, A.K. (1997) *The Endogeneity of the Optimum Currency Area Criteria,* NBER Working Paper, No. 5700, pp. 1-33, accessed on June 2012 at http://akson.sgh.waw.pl/~cwojcik/teaching/ee_fall/Edogeneity%20Frankel%20and%20Rose.pdf.

Grubel, H. (1970) *The Theory of Optimum Currency Areas*, Canadian Journal of Economics, Vol. 3, No. 2, pp. 318-324, accessed on June 2012 at http://www.jstor.org/pss/133681.

Kowalski, T. (2012) *The economic and monetary union countries vs. the global crisis*, MPRA Paper, No. 37942, pp. 1-33, accessed on September 2012 at http://mpra.ub.uni-muenchen.de/37942/1/MPRA_paper_37942.pdf.

McKinnon, R. (2002) *Optimum Currency Areas and the European Experience*, Economics of Transition, Vol. 10, pp. 1-20, accessed on september 2012 at http://www.stanford.edu/~mckinnon/papers/optimumreveur.pdf.

Mundell, R.A. (1961) *A Theory of Optimum Currency Area*, The American Economic Review, Vol. 51, Issue 4, pp. 657-665, accessed on July 2012 at http://people.ucsc.edu/~hutch/Econ241a/Articles/Mundell.pdf.

Obstfeld, M. (1998) *A strategy for launching the Euro*, European Economic Review, Vol. 42, pp. 975-1007, accessed on September 2012 at ftp://libgen.org/!upload/silverware/journals/EER/1213.pdf.

Shambaugh, J.C. (2012) *The Euro's Three Crises*, Brookings Papers on Economic Activity, pp. 1-54, accessed on June 2012 at http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2012_spring_bpea_papers/2012_spring_BPEA_shambaugh.pdf.

Volz, U. (2012) *Lessons of the European Crisis for Regional Monetary and Financial Integration in East Asia,* ADBI Working Papers Series, No. 347, pp. 1-23, accessed on September 2012 at www.adbi.org/files/2012.02.21.wp347.lessons.european.crisis.east.asia.pdf.

***Eurostat, *Euro area and EU27 Government deficit at 4.1% and 4.4% of GDP respectively,* available at http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22102012-AP/EN/2-22102012-AP-EN.PDF.

***IMF, *World Economic Outlook, April 2012,* available at http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/text.pdf.