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Fiscal and economic stability in the eurozone [1]

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Every day the news is filled with increasingly depressing news about the economy. The recent Autumn Statement (29 November 2011) to the House of Commons by UK Chancellor of the Exchequer, George Osborne, confirmed that the cause of a potential ?double dip? recession in the British economy lay largely at the doors of the European Union and, in particular, the eurozone. It is easy to understand why some commentators feel that perhaps the European single currency is in its death-throes, and that the European Union itself needs major structural revisions. But for the sake of perspective it is important to remember the underlying rationale behind the ?European project? which remains as relevant today as it did in the 1950s.

The origins of the EU lie with the formation of the European Coal and Steel Community (ECSC) and the European Economic Community (EEC), which were formed in 1958 by Belgium, France, West Germany, Italy, Luxembourg and the Netherlands. The primary rationale at the time was to find a way to put behind the enmity that had led to two World Wars being fought primarily on European soil during the twentieth century. It was believed that when nations trade freely with one another they are less likely to engage in hostilities (in addition to the potential economic benefits as outlined in Ricardo?s Principle of Comparative Advantage). Seen from this perspective the EU has been something of a success, with Europe being a peaceful region and one that is likely to continue as such for the foreseeable future.

However, since the start of the financial crisis in 2007, and the consequent recession of 2008?2009, both banks and governments have found themselves under increasing financial pressures. In particular, while governments were happy to borrow increasing amounts during the ?years of plenty? before the financial crisis, the lack of more recent economic growth has seen fiscal deficits grow in some countries to unsustainable levels. This was especially the case with Eire, which required an EU-IMF bailout in 2010 to assist both the government and Irish banks. The imposition of austerity measures since then appears to have been relatively successful, although the government may yet require further funding from the European Financial Stability Facility (EFSF).

While the fiscal problems in Eire were dealt with relatively quickly and decisively, this has not been the case with the EU more recently. It is increasingly clear that the continued failure to tackle fiscal uncertainty in the eurozone has the potential to generate a recession far worse than that of the ?Great Depression? of the inter-war years of the 20th century. The prolonged and monotonous euro-crisis debate among Europe?s capstone political, financial and economic leaders has so far produced very little decisive action, largely as a result of competing, entrenched national interests. The outcome has been a series of too-little, too-late agreements on stimulus packages in some countries and austerity measures in others. Decisions that have actually been made by eurozone leaders have fallen short of inspiring the confidence necessary to prevent financial collapse. The more fiscally-troubled nations, such as Portugal, Ireland, Italy, Greece and Spain (PIGS or PIIGS), have experienced severe economic and financial problems, leading to outbreaks of unrest and sometimes violence on the streets. The potential social and political consequences of fiscal retrenchment by government in the PIIGS is more stark than in the wealthier nations of the eurozone. The contrast between national and broader EU/eurozone interests has brought clearly into focus the question: is there a solution that European leaders might make to offset the possibility of widespread sovereign and commercial default?

Despite some attempts to introduce emergency stimulus packages in wealthier eurozone countries and austerity measures in countries with increasingly untenable sovereign debt problems, the financial damage has become deep-seated. Because banks in the EU have bought much of the debt of the PIIGS governments, many major banks have found their balance sheets further stretched (beyond that induced by the financial crisis), with the fear of possible insolvency if the sovereign debt issue is not rapidly resolved. Despite the presence of record levels of expansionary monetary policy (or ?quantitative easing? as it has become known) in many countries, the further fear of contagion has led to the European economy stalling. There is every likelihood of a ?double dip? recession in the EU as the government budgets of usually stable states such as Germany, France and the Netherlands become too limited that they are unable to deliver any large amounts of funds to ?failed nations? without incurring dangerous levels of debt themselves. The IMF has been encouraged to take all necessary steps to ensure that the eurozone does not fall to a point where there is no hope of salvation. In some quarters it has been suggested that the assistance of China should be sought, although even China has experienced a reduced level of economic growth recently. UK Chancellor, George Osborne, has urged that the eurozone seriously considers a ?culling? of certain nations from the eurozone, with a return to their previous national currencies as a first step towards rebuilding their economies, and repaying their debt with a currency which might help promote favourable exports and slow but independent growth. However, any secession of countries from the eurozone is likely to be regarded negatively, both for the eurozone per se and for those countries unable to meet the conditions necessary to remain within.

Interest rates on government and corporate bonds have risen recently within the eurozone, partly as a result of bond market forces but also as the result of downgrades by the ratings agencies. Naturally, there is a limit to the levels of financial stress that countries can incur while maintain conditions necessary to remain in the EU. However, the alternative would bring into question the entire existence of the ?European project?, potentially leading to the destruction of the EU as a major economic entity, something unthinkable given its origins.

We believe that there are benchmark decisions that can be made to prevent the further systemic meltdown of the eurozone. The following are feasible actions that might be considered for the eurozone to rise out of the abyss of uncertainty and avoid an inevitable doomsday ending:

? **Borrowing**: Macroeconomic theory suggests that government borrowing to fund initiatives (?priming the pump?) that can lead to economic growth is one possible solution to a recession. The economy is given a kick-start which improves business confidence so that the private sector?s expectations are revived, fuelling further economic growth. However, the current recession is no ordinary recession. However, many governments are already borrowed to the point where their creditworthiness becomes questionable. The recent (23 November) failure of the German government to sell all of its offered bonds (?bunds?) and the concomitant rise in yields is an indicator of the market?s sense of German government creditworthiness. This should come as no surprise. The original thinking behind government borrowing as a counter-recessionary element (Keynes 1936), also talks of governments running repaying debt and running budget surpluses during the years of economic growth. However, it has long been clear that many politicians have abused this technique in an attempt curry favour with their voters, by generating above-trend levels of growth. However, while borrowing during the ?good years? has been occurring since the 1960s, the long run of growth during the 1990s has led to excessive, unsustainable levels of debt, particularly in the more peripheral countries of the EU. One of the conditions behind this was the eurozone itself: instead of accepting the reality of the situation and allowing default, other eurozone members decided that the solution to this is further debt in the form of ?bail-out packages?.

? **A properly functioning single currency**: The EU failed to develop a meaningfully functioning system for seventeen nations to share a single currency. Pioneered by Robert Mundell, the conditions for a single currency (or ?optimal currency area?, OCA) have been well defined for long enough to be part-and-parcel of every textbook in International Finance. The four most commonly-cited criteria include:

- Labour mobility across the region.
- Capital mobility and price and wage flexibility across the region.
- A risk-sharing mechanism, such as an automatic fiscal transfer mechanism to transfer funds to areas adversely affected by 1 and 2. Usually this takes the form of taxation redistribution.
- Participant countries have similar business cycles.

Despite their trading connections, it was always going to be difficult for different European economies, with diverse backgrounds (historical, political, social, fiscal) to ensure the long-run success of a single currency arrangement. This was particularly the case when most of the conditions for an OCA were not in place. One innate problem was that before the euro was established, countries considered ?risky? had to pay more (in the form of higher interest) to attract skeptical investors. With the implementation of the euro, a common consensus grew up to the effect that the eurozone countries would ?stick together? to ensure that the debt is repaid. Risky countries (such as the PIIGS) came to be considered safer, and were consequently able to borrow a lot more, even though the actual risk was virtually unchanged. Now that the possibility of default is apparent, with very high levels of debt it has become a very real burden for the other, less risky nations to help out, and some degree of animosity has replaced togetherness.

? **The cultural mindset**: By looking superficially into the notion that debt-ridden Italy could be considered a ?spendthrift playboy?, in Spain the throwaway phrase ?less-is-more? is often factored in when companies slash their employent levels, and the reaction of many Greek people reacting to the possibility of necessary austerity measures has been ?it?s the government?s fault and everyone is still enjoying their wine and weather?, it is clear that the cultural mindset in these countries forms an element of the problem. With Greece, there is a clear sense that a large section of the Greek population would like to have their cake and eat it too. That is to say, the other EU members must use a portion of their tax revenues to attempt to bail out the Greek government. In order to get the Greek economy back onto the path of sustainable growth, they also place conditionality conditions, regarded as austerity measures which diminish the Greek ability to live a lifestyle that they can no longer afford. The November 5th-11th issue of The Economist pointed out in an article that ?the polls show that 60% (of Greek citizens) are against the rigorous terms of the bailout, but 70% want to stay in the euro?. Coupled with Papandreou?s talent for infuriating President Sarkozy, Chancellor Merkel and even his own partners by calling for a referendum on the euro crisis, makes tensions among the Eurozone members even greater. This contrasts with the Irish, who demonstrated initially against the austerity measures, but rapidly became persuaded that such measures were indeed necessary for the long-term future of the Irish economy.

It is clear that stabilising the PIIGS is key to restoring confidence and hence stability to the eurozone. What is required swiftly is a detailed assessment of whether or not it would be beneficial to allow them to default, implement non-negotiable austerity measures combined with structural reforms, implement further bailout packages (with the use of a combination of funds from Eurozone members and foreign assistance), or to decide in eliminating some or all PIIGS from the eurozone, on the grounds that they might be better able to grow without the euro.

To conclude, it is clear that certain decisions need to be made by the member-leaders of the Eurozone and this paper consequently suggests the following:

? Countries such as Greece, Portugal, Spain and Ireland need to come to terms with the possibility of default. They must quickly analyse predict the consequences of two key scenarios: what would happen in the event of a default, and evaluate if they would be better or worse remaining within the eurozone or attempting to solve their problems by regaining their monetary sovereignty with a return to their national currency. Putting aside the costs of a currency change, it is likely that this latter path would lead to increasingly worse debt ratings and a depreciation of the national currency. Unless there were growth in the trading partners? economies it is hard to see any economic benefits from such a choice.

? Structural reform should be given a higher priority than tax increases and spending cuts. With Greece, a judicious budget devised by the region?s top economic advisors and finance ministers, might be able to put what little government capital that the Greeks possess to good use. Meanwhile, the private sector of Greece could begin to aim for growth without having to pay increasing amounts of taxes. Corporate tax could be made low enough to attract foreign and local entrepreneurs to start new businesses within Greece, and make the climate more favourable for investors who might wish to purchase government and corporate bonds.

? There should be more greater and clearer scrutiny of the conditions for monetary union among eurozone leaders. The sovereign debt crisis is a clear example that in troubled times the single currency can become a problem rather then the cause for good for which it was designed. Certain countries must therefore contemplate whether a temporary or permanent return to their currency before the monetary union is a good option towards the path to stability. Equally, the EU needs to consider fully implementing the conditions for OCA to improve the euro in the future. This should include further political integration of the eurozone states, with a fully democratic and accountable European parliament, closer to the model established in the USA. For wealthy European countries such as the UK, whose currencies are very widely traded, with fully functioning futures and options currency markets, the necessity of joining the eurozone is less clear.

? Lastly, in working together to solve the recent series of unfortunate events, the eurozone members need to put their differences aside and focus their mindset on stability. This requires a change from narrower national interests towards a stronger focus on European interests. It is a given that countries such as Germany, France and the Netherlands are a lot more affluent than the PIIGS, and that must be used as a non-biased benefit for the greater good of the union. German taxpayers should not bicker about their money being ?wasted? on failed governments, but rather as a pursuit for safeguarding the economic climate of the entire region. Conditionality should ensure that moral hazard does not become a longer-run issue. Likewise, the PIIGS should not view the aid and measures given as a loss of sovereignty but more so an opportunity to repay, reform and repair their economy in an orderly, humble and productive manner as part of a much larger club.

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