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Political Economy of the Euro Area Crisis

Summary: For many experts the true motivation behind the introduction of a single currency in Europe is political rather than economic. This view is based on the fact that the euro area does not constitute an optimal currency area and, therefore, the costs of monetary integration are likely to outweigh the benefits. In particular, the loss of control over monetary policy and exchange rates make overcoming asymmetric demand-side shocks very painful. Moreover, the monetary union lacks a common fiscal authority that could help in smoothing out business cycles. The present crisis exposed these vulnerabilities and, unfortunately, so far economic policies adopted in the region have failed to rectify these shortcomings.

Key words: European monetary union, Optimum currency area, Asymmetric shocks, Fiscal and monetary stabilization policies.

JEL: F59, E63, O52.

Numerous economists, for instance, David E. W. Laidler (1991), Martin Feldstein (1997), Paul De Grauwe (2000), and Ben S. Bernanke (2005), claim that the European monetary union is rather a political than an economic endeavor. This conclusion originates in the fact that the countries admitted to the union do not meet the criteria of Optimum Currency Area (OCA) theory (Barry Eichengreen 1992; and Michael Artis, Marion Kohler, and Jacques Mélitz 1998) as spelled out in Robert A. Mundell (1961), Ronald I. McKinnon (1963), and Peter B. Kenen (1969). If nations that form a monetary union do not form an OCA, then the costs related to the loss of control over monetary policy and exchange rates may outweigh the benefits resulting from the elimination of foreign exchange risk (greater volume of trade and closer economic integration).

Vaclav Klaus (2004) quotes numerous politicians openly admitting that the monetary union is a political act. Similarly, a former European Union ambassador to the United States, stated that "[i]f an underlying rationale for the Economic and Monetary Union [EMU] was economic, the deepest reason for such a move was profoundly political" and added that it was designed to "strengthen Europe's voice in the world (Günter Burghardt 2005, pp. 24-25)."

1. Asymmetric Shocks

Potential economic costs to a monetary union may be particularly high in the face of adverse asymmetric demand-side shocks, i.e. disturbances that affect only certain industries or geographic regions, like the present financial crisis. The relative under-

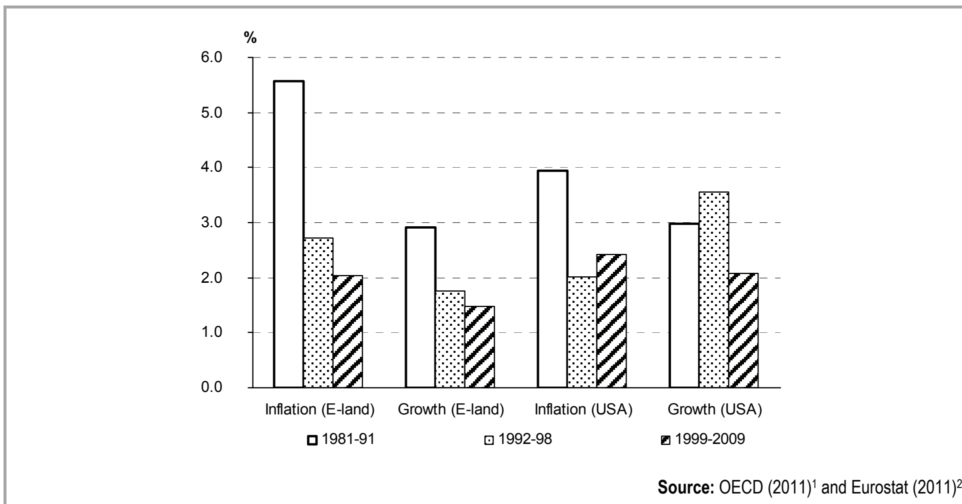
performance of the euro area (17 countries), as compared to that of the United States, presents some evidence that the establishment of a single currency hamstrung the European economy (Table 1). These developments simply confirm trends that have been in place since the very beginning of monetary integration (Kazimierz Dadak 2008, see also Figure 1).

Table 1 GDP Growth (%)

Country	2008	2009	2010	2011*	2012*
Euro area (17)	0.4	-4.3	1.8	1.6	1.8
Greece**	1.0	-2.0	-4.5	-3.5	1.1
Ireland	-3.0	-7.0	-0.4	0.6	1.9
Italy	-1.3	-5.2	1.3	1.0	1.3
Portugal	0.0	-2.5	1.3	-2.2	-1.8
Spain	0.9	-3.7	-0.1	0.8	1.5
USA	-0.3	-3.5	3.0	2.6	2.7

Note: * Forecasts; ** Provisional data.

Source: Eurostat (2011).



Source: OECD (2011)[1] and Eurostat (2011)[2].

Figure 1 Euroland and USA, Inflation and Growth (Annual Average, %)

Kenen (1969), Paul Krugman (1993) and De Grauwe (2000), among others, stress that a high degree of labor mobility and, what is now called "fiscal federalism", are very helpful in overcoming harmful effects of asymmetric shocks.

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[1] **Organization for Economic Cooperation and Development.** 2011. StatExtracts. http://stats.oecd.org/index.aspx (accessed September 2, 2011).
[2] **Eurostat.** 2011. Statistics. http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database (accessed September 3, 2011).

The Commission of the European Communities (1990) notes that the American labor market is much more flexible than its European counterpart. Similarly, Paul R. Masson and Mark P. Taylor (1993) show that the mobility of labor within Germany is much lower than the mobility of this resource across the United States. Moreover, they reach a conclusion that labor mobility among the European Union nations is lower than among the German *Länder*.

Countries that formed a monetary union must be "armed with a wide array of budgetary policies to deal with the stubborn 'pockets of unemployment' that are certain to arise from export fluctuations combined with an imperfect mobility of labor (Kenen 1969, p. 54)." But, the European Commission collects a tiny fraction of all taxes and has extremely limited ability to respond to economic challenges in general and asymmetric shocks in particular. Therefore, Michael M. Hutchison and Kenneth M. Kletzer (1995), Tamim Bayoumi and Masson (1998), and Michael D. Bordo and Harold James (2008) stress this major weakness of the European project. Automatic stabilizers can be helpful in overcoming asymmetric shocks, too. Xavier Sala-i-Martin and Jeffrey Sachs (1992) and Masson and Taylor (1993) find this to be true for, respectively, the United States and Canada.

On the other hand, Jeffrey A. Frankel and Andrew K. Rose (1996) argue that countries that *ex ante* do not constitute an OCA could become one. They find that an increase in trade may lead to more highly correlated business cycles. This, in turn, better insulates members of a monetary union from the harmful effects of asymmetric shocks. In sum, a country that on the basis of past experiences may be a poor candidate for entry into a monetary union *ex post* may meet the OCA criteria.

2. Maastricht Criteria

The Treaty on European Union (Maastricht Treaty) established, among other things, the limits on annual budget deficits and total national debts, as well as, a central bank completely independent of any national or European Union (EU) authorities.

The 3 percent maximum annual budget deficit and the total debt ceiling equal to 60 percent of Gross Domestic Product (GDP) were later confirmed in the 1997 Stability and Growth Pact (SGP). Moreover, the SGP envisaged very severe penalties for the violation of the above principles, especially regarding the budget deficit level. Peter Bofinger (2003), Willem Buiter et al. (1993), De Grauwe (2000), and Eichengreen (2003), among others, show that the restrictions have no theoretical basis, however.

The degree of European Central Bank's (ECB) sovereignty is without precedent (Forrest Capie 1998). Moreover, the bank has to accomplish a single primary goal—price stability (Council of the European Union 2010a, art. 127). Pascal Lamy and Jean Pisani-Ferry (2002) reveal that from the very beginning the ECB made every use of its statutory independence and refused any outside influence. This makes any synchronization of fiscal and monetary policies very difficult. However, Kenen (1969) argues that an area possessing a common currency should have a single authority to tax and spend, to make sure that a policy mix is optimal, i.e. assures full employment. Andrew Hughes Hallett (2005) confirms that policy coordination can lead to a faster rate of economic growth and lower unemployment without higher inflation.

3. The Euro's First Decade

Europe's economic performance over the first decade offers a mixed picture. A proponent proclaims that "the euro has been an undisputed success (Joaquin Almunia 2009, p. 17)." Menzie D. Chinn and Frankel (2008) predict that the currency may soon displace the American dollar as the most important reserve currency. McKinnon (2004) also notes a very significant decrease in the rate of inflation across the member nations and the resulting decline in interest rates.

Nevertheless, these encouraging events did not suffice to promote more investment spending and, consequently, to stimulate an increase in the rate of economic growth. In the decade preceding the establishment of the Maastricht Treaty, the euro area and the United States were growing at a very close rate, but beginning with the convergence period their growth rates have diverged (Figure 1). In 1999-2006 "the countries in the Euro zone exhibited significantly lower growth rates … than the remaining OECD countries (Thushyanthan Baskaran 2009, p. 351)."

Moreover, the monetary union failed to deliver another critical benefit, namely significantly more trade among its members and a greater degree of economic integration. Richard Baldwin (2006) found that the introduction of the common currency resulted only in a small, one time spurt in trade of between 5 and 10 percent. As the deepening of trade relations failed to materialize, the anticipated by De Grauwe (2000) convergence of European economies did not take place or progressed at a much slower pace. Consequently, the entire euro area fell short of becoming more economically similar and, thus, less vulnerable to asymmetric shocks. This development also casts a doubt on the endogeneity of OCA hypothesis put forth by Frankel and Rose (1996).

4. European Union's Response to the Crisis

The response of the European Union to the current crisis has been selective. On one hand, Hungary, a country that joined the EU, but not the monetary union, was denied any support; it had to call on the International Monetary Fund (IMF) for help. Similarly, Poland obtained a credit line from this multilateral organization rather than from the European Union. On the other hand, Greece, Ireland, and Portugal, all euro area members, received financial assistance from other Euroland members, despite the alleged Maastricht no-bailout clause.

Consequently, the European Financial Stabilisation Mechanism (EFSM) was founded in May of 2010 (Council of the European Union 2010b). This initiative resulted in the establishment of the European Financial Stability Facility (EFSF) (Council of the European Union 2010c), a corporation with total financial resources equal to 440 billion euros. This facility can be augmented with up to 60 billion raised by the European Commission and up to 250 billion from the IMF (European Financial Stability Facility 2011). The structure of the bailout mechanism shows that the European Union is either reluctant or incapable of acting on its own, because as much a third of the aid is funded by the IMF.

In mid-2013 this facility will be replaced with a permanent crisis management tool, the European Stability Mechanism (ESM) with a total subscribed capital of 700

billion euros (European Council 2011). An important feature of this new program is that it will lend money exclusively to the euro area member-states on the basis of "a stringent programme of economic and fiscal adjustment and on a rigorous debt sustainability analysis conducted by the European Commission and the IMF, in liaison with the ECB (Council of the European Union 2010d)." In sum, the idea to make the European Union a "transfer union" was quickly quashed (*The Economist* 2010). Therefore, the prospects for further fiscal integration and the overcoming of well-known shortcomings of the monetary union in this respect are dim.

The Board of Governors of ESM will include only representatives of the Euroland. The European Commissioner for Economic and Monetary Affairs and the President of the ECB will serve only as observers. Moreover, the voting power of a governor will be proportional to his or her member state's contribution to the ESM. This is an evident departure from the usual voting procedures within the European Union, which offer protections to smaller countries; for instance, every member of the euro area appoints one director to the ECB's Board of Directors and each director enjoys the same voting privileges.

The efforts to overcome the effects of the crisis also demonstrate the limits to the European Union; the institution has no significant financial resources of its own—of the 750 billion euro-large EFSF only 60 billion euros come from Brussels.

The ESM is a product of the Eurogroup, a committee composed only of finance ministers of the euro area. This entity is not listed as a governing body in any of the European Union treaties; nevertheless, it earned a blessing of the European Commission (2008, pp. 287-293). The recognition of the Eurogroup may strengthen the euro externally in line with suggestions made by, for instance, Benjamin J. Cohen (2011), but its existence adds to the complexity of economic governance within the European Union. Moreover, this development is in stark contrast to other efforts to bring all members of the European Union into a closer alliance, in particular the Lisbon Treaty, which produced a president and a foreign minister for the entire region (Council of the European Union 2007).

5. Economic Policies Adopted to Overcome the Crisis

A visible feature of the current European approach to the crisis is the insistence on strict adherence to criteria enshrined in the SGP. But, economists point to numerous shortcomings of the Pact and make various proposals to change it, especially to make it more flexible. An excellent overview of that discussion can be found, for instance, in Iain Begg and Waltraud Schelkle (2004) and Antonio Fatás et al. (2003).

The European leaders' approach seems to be rooted in the "German view" of fiscal policy, which challenges the standard Keynesian position that a decrease in government spending has a negative effect on aggregate demand; instead it stresses the negative impact of budget deficits on total demand (Francesco Giavazzi and Marco Pagano 1990). Giavazzi and Pagano (1990) claim that Denmark and Ireland attained much better economic performance after the nations substantially lowered budget deficits and they called these events "expansionary fiscal consolidations (EFC)." The logic behind EFC is that decreasing deficits produces expectations of lower taxes and higher incomes and, consequently, increases private consumption and, thus, prevents a contraction in aggregate demand.

However, Michael U. Bergman and Michael M. Hutchison (1999) analyze 15 cases of significant fiscal consolidations that occurred in the OECD countries in 1975-95 and found that most countries that adopted such polices underwent recessions, and in only three instance the expansion was associated with a strong increase in consumption (Denmark, Ireland and Sweden). As far as the Danish case is concerned, the authors observed that other elements played an even more important role, in particular favorable terms of trade and supply-side and cyclical factors. Moreover, they note that the upswing was short-lived, after three years the Danish economy suffered sharp downturn. Regarding Ireland, "buoyant world demand, improvements in cost competitiveness, and an inflow of foreign investment… more than outweighed the short-run contractionary effects of fiscal contraction (Frank G. Barry and Michael B. Devereux 1995, pp. 260-261)."

Hughes Hallett and Peter McAdam (1998) and Gabriele Giudice, Alessandro Turrini, and Jan in' t Veld (2003) emphasize the importance of a proper policy mix; contractionary fiscal policy must be combined with accommodating monetary policy. Furthermore, "sufficiently strong trend growth of real GDP is a necessary condition for the sustainability of public finances in EMU (Giudice, Turrini, and in' t Veld 2003, p. 52). "It is extremely difficult to imagine that any of these conditions could be met in the euro area under present conditions. Additionally, Alberto Alesina and Roberto Perotti (1996) postulate that reductions in government spending, as opposed to those that aim at enhancing revenue, are much more likely to result in a lasting improvement in macroeconomic performance. But all drastic reductions in budget deficits presently enacted in the Euroland involve tax increases.

The polices currently adopted in the euro area also go against the opinion of an overwhelming majority of American economists who believe that in times of major economic slowdown expansionary fiscal policy has a "significant stimulative impact" (Richard M. Alston, J. R. Kearl, and Michael B. Vaughn 1992, p. 204). Similarly, Philip Arestis (2011) shows that fiscal policy is a crucial factor that affects economic performance. Alan S. Blinder and Mark Zandi (2010) believe that the stimulus package adopted by the Obama administration in 2009 saved the United States from another Great Depression. Marco Ratto, Werner Roeger, and in' t Veld (2006) find that in the euro area not only automatic stabilizers, but also discretionary fiscal policy is effective in stabilizing GDP.

On the other hand, so far, the policy of reinforcing SGP has disappointed on some fundamental metrics. Arestis and Theodore Pelagidis (2010) point to the likelihood that the austerity policies may eventually force some of the EMU countries to default on their debts. As a matter of fact, the fourth review of economic progress in Greece revealed that the actual budget deficit in all of 2010 was 1 percent higher than had been previously estimated (European Commission 2011). In the first quarter of 2011 Greece experienced further deterioration in government finances and "the ESA-based deficit for the year as a whole would be in excess of 10 percent of GDP, virtually the same of 2010 (European Commission 2011, p. 25)" as opposed to the planned 7.5 percent shortfall. Consequently, last July economic ministers of the euro area were forced to adopt a new bailout plan for Greece (Laurence Norman and Nathalie Boschat 2011). Eurostat (2011) predicts that, with the exception of Ireland in

2012, Greece, Ireland, and Portugal will grow at rates below the Euroland's average (Table 1).

Also, monetary stimulus in Europe is small, compared to that in the United States. The Fed has to achieve both stable prices and full employment, while the Maastrich Treaty charges the ECB with just the former goal (Patricia S. Pollard 2003). Therefore, the Fed enjoys much greater flexibility in addressing demand-side economic shocks and it takes full advantage of this freedom. On the other hand, already in the early stage of this crisis the ECB proclaimed that it "remains strongly committed to preventing second-round effects and the materialisation of upside risks to price stability over the medium term" in spite of expected slow economic growth and "uncertainty about the prospects for economic growth [being] unusually high (Jean-Claude Trichet 2008)." In April of 2011 the central bank increased interest rates at the very first sign of economic rebound (Trichet and Vitor Constâncio 2011).

6. Market Reactions

So far, actions undertaken by the Europeans have had a very limited impact, if any. Greece, Portugal, and Ireland are unable to reenter financial markets; yields on long-term bonds issued by these countries remain at levels that are not sustainable. Figure 2 shows that market rates on 10-year government bonds sold by these countries have increased following the rescue packages. Similarly, yields on long-term Italian and Spanish bonds have substantially crept up since October of 2010. On the other hand, borrowing costs of the United Kingdom and Sweden, nations that decided not to join the euro area, have remained relatively very low and close to those of Germany, the euro area's benchmark (see Figure 2).

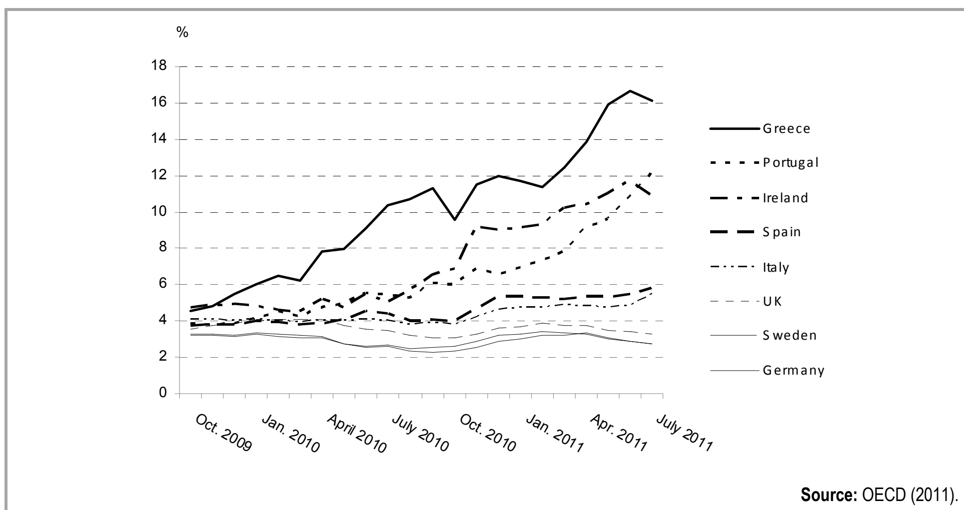

Figure 1 Yield on Long-Term Sovereign Bonds (Monthly Average, %)

Overall, the crisis shows beyond any doubt that it is not membership in a monetary union, but the creditworthiness of a borrower that determines the cost of funds. Major rating agencies keep cutting down the ratings on sovereign debt issued by Greece, Portugal, and Ireland, as well as that of Italy and Spain. Similarly, a majority of European economists predict that Greece and Ireland will default on their obligations (Andrew Walker 2011). Consequently, none of the nations that received funds from the EFSF and committed itself to intense austerity measures has managed to lower its borrowing costs.

7. Conclusions

Many economists claim that the monetary union in Europe is a political rather than an economic enterprise, because the region does not meet OCA requirements, has low labor mobility and lacks a central fiscal authority. For these reasons, the euro area is prone to asymmetric demand-side shocks and lacks effective defenses against such adverse developments, except for deflation. The current crisis in several member-states, especially in Greece, Ireland, and Portugal supports these views and casts a shadow over the future of the euro.

The steps that the leaders of the euro area undertook to address the present crisis show that the region lacks political unity. The proposed ESM is designed to be an emergency facility; its funds will be disbursed only under very strict conditions and exclusively to members of the euro area. Consequently, in breach of European solidarity, the European Union is divided into two economic tiers, the euro area and the rest. The governance of ESM is based solely on economic power of a member-state. The position of the European Commission and, especially, of the European Parliament is weakened; it is the individual state that wields power. Moreover, the mechanism cannot be used to turn the region into a transfer union and, thus, make it more cohesive and competitive.

Financial markets are leery about the prospects for success in attaining financial stability in Greece, Ireland, and Portugal and, consequently, interest rates that the nations are expected to offer on loans are prohibitively high. Moreover, yields on sovereign debt offered by some other euro area members have drifted upwards. Similarly, rating agencies keep downgrading debt issued by the periphery. Therefore, the prospects for a quick economic recovery remain dim.

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