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The Politics and Economics of the Euro Crisis
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The Euro: A Crisis of the Currency or a Failure of Politics?

Summary:

Overall the monetary pillar of the EMU project has worked well so that it is incorrect to speak of a 'euro' crisis though it is at the epicentre of the present crisis. The origins of the problems it is facing have more to do with the economic component, particularly because of the breach of budgetary rules which points to a failure of politics. Hence the solution must be political, namely a strong commitment by governments to achieve balanced budgets and implement structural reforms so as to lay the basis for improved competitiveness, job creation and sustainable growth.

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Introduction

The title I have chosen for my remarks may sound provocative or even simplistic given the complexity of the subject, but I have done so for a reason. My purpose is not indeed to suggest that there is a straightforward answer to the question, but rather to permit a better focus on the two major actors in the current scenario: the governments of the euro area countries, on the one hand, and their common currency, on the other. Their predicament, which I shall discuss first, has been aggravated by various other actors whose behaviour, in a world of globally integrated economies and financial markets, has helped to transform a weakness that was latent in the design of Europe's Economic and Monetary Union (EMU) into a sovereign debt crisis that is threatening the very existence of the euro itself.

Economic and Monetary Union (EMU) – the rationale

From the perspective of economic theory, the decision to start Stage III of EMU in January 1999 was unprecedented. It was nothing less than an act of faith in the capacity of governments to reconcile their agreement to give up their national currencies and monetary policies to a supranational central bank with their decision to retain national control over fiscal and economic policies. This asymmetry in the macroeconomic policy framework represented a major challenge because the euro would in effect be a currency without a State. Moreover, it was clear that not all the eleven countries that were allowed to enter EMU satisfied the convergence criteria laid down in the Maastricht Treaty.

EMU did not then have the characteristics of an optimum currency area and that decision was clearly taken on political rather than economic grounds. This led many knowledgeable observers to predict the experiment's early demise. Milton Friedman, for example, anticipated that the monetary union would collapse within five years.[1]

Altogether, therefore, the omens were not favourable at all. And yet, when viewed against this background the track record looks surprisingly good. With regard to employment, for example, some 14 million jobs have been created in the euro area since the launch of the single currency, compared with around 7 million in the United States, a more integrated single market of comparable size. As for the monetary dimension of EMU, the euro has retained its value and even today remains stronger against the dollar than in its early days. It has become established as the second most important global currency after the dollar and is roughly at par with it as a unit for the denomination of credit. The euro has also become a major reserve currency.

At the same time, the euro's central bank, the ECB, has achieved its primary objective. Annual inflation has averaged 2.0% since the birth of the currency, in spite of the considerable fluctuations in commodity prices, especially oil prices, in the recent past. In addition, confidence in the euro is reflected in the fact that long-term inflation expectations have remained anchored around the ECB's definition of price stability and are currently at 1.8%. Stable inflation expectations are central to economic prosperity since they allow businesses and households to plan ahead without concern about price and cost shocks.

Overall, therefore, the monetary pillar of the EMU project has worked well so that it is incorrect to speak of a 'euro' crisis. The euro may well be at the epicentre of the current turmoil, but the origins of the problem have more to do with the economic component of EMU, particularly because of the breach of the budgetary rules.[2] This is an aspect of what I have called 'the failure of politics'.

At this point it is pertinent to recall that the tendency of governments to run deficits and to shift the resulting debt burden onto future generations predates the euro. For example, deficits of around 4-5% of GDP were widespread in the countries that now form the euro area so that the average stock of debt increased from around 35% of GDP in 1980 to 75% by the mid-nineties.[3]

Imprudent fiscal policies can have detrimental effects on growth by pushing up interest rates, thereby discouraging private investment. The deficit bias is further exacerbated in a monetary union due to the elimination of exchange rate risk and the narrowing of risk premia, which, prior to the creation of the single currency, used to impose an element of market discipline on profligate countries.

Such indiscipline also has negative implications for monetary policy, as fiscal expansion can boost aggregate demand, thereby giving rise to inflationary pressures. Of even greater concern, persistent increases in the debt level can lead to the fear that government spending would ultimately be financed by money creation, with a detrimental impact on prices.

Here it must be acknowledged that the founding fathers were not unaware of these dangers. The Maastricht Treaty in fact laid down some basic rules governing national fiscal policy and the avoidance of excessive deficits. Then in 1997 the Stability and Growth Pact (SGP), which, along with the European Central Bank (ECB) constitutes the institutional framework of EMU, set out detailed provisions of both a preventive and a corrective nature. For example, it prohibits fiscal deficits from exceeding 3% of GDP. More importantly, the SGP stipulates that countries should aim to balance their budgets over the economic cycle, by running surpluses in good times in order to have ample room for manoeuvre during downturns, allowing automatic fiscal stabilizers full play without breaching the reference value.

Finally, apart from adhering to the underlying value of fiscal prudence, countries were expected to coordinate their economic policies and adopt market-oriented reforms. This, in turn, would lead to sustained macroeconomic convergence among euro area countries and help prevent the accumulation of imbalances. In addition, an ambitious agenda of supply-side initiatives, the Lisbon Strategy, was devised to expand the EU's growth potential.

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Mr Bonello was initially appointed Governor of the Central Bank of Malta for a period of two years in October 1999. His appointment was extended for a further two-year period in 2001, and subsequently for five-year terms in 2003 and 2008. He relinquished the post at his request in June 2011. Previous to his appointment as Governor, Mr Bonello was a senior official of the United Nations Conference on Trade and Development (UNCTAD) in Geneva.

After obtaining a degree in languages and economics from the University of Malta in 1965, Mr Bonello pursued his studies as a Rhodes Scholar at the University of Oxford, where he was awarded an honours degree in Philosophy, Politics and Economics in 1969 and an MA in 1973. He served as a Senior Research Officer at the Central Bank of Malta from 1971 to 1978. Mr Bonello was also President of the Malta Branch of the Chartered Institute of Bankers, now the Institute of Financial Services. In 1978 he left the Bank to join the private sector, where he held senior management positions and sat on the Councils of the Chamber of Commerce and the Federation of Industry until he joined UNCTAD in 1983.

During his tenure as Governor, Mr Bonello was a member of the Governing and General Councils of the European Central Bank (ECB) and of the European Systemic Risk Board (ESRB). He continues to be a member of the Board of Governors of the Malta Financial Services Authority (MFSA).

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The economic pillar of EMU: the failure of politics

In brief, therefore, the absence of monetary and exchange rate independence at the national level placed the onus on prudent budgetary, wage and structural policies. Unfortunately, it was already becoming evident by the middle of the past decade that national policies were not always compatible with the requirements of a monetary union. The financial crisis that erupted in 2008 has accentuated this weakness.

On the fiscal front, both the preventive and corrective arms of the SGP failed to discipline governments and several countries registered deficits even in good times. By 2003, five of the twelve euro area countries were in breach of the SGP. This disappointing record undermined the credibility of the Pact, which became most apparent when the ECOFIN Council decided to put on hold the excessive deficit procedure for France and Germany in 2003, under pressure from these same two countries. It is indeed ironic that Germany, whose Chancellor at the time stated publicly in a letter to the *Financial Times* that his country would not have its fiscal policy decided in 'Brussels', had been the most ardent proponent of the SGP and is today preaching the virtues of fiscal rigour to highly indebted countries as the only solution to the crisis.

At the same time, euro area countries have also diverged in their competitive positions and in their external balances.[4] Some countries registered strong gains in price and cost competitiveness relative to the other members, while others showed a substantial deterioration. Large and persistent divergences were particularly pronounced in unit labour costs (ULC): between 1999 and 2007, cumulative ULC growth was a modest 2.3% in Germany and 5.9% in Austria, but exceeded 20% in Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.[5]

These differences in cost competitiveness were in turn often reflected in marked divergences in real effective exchange rates and in current account positions. The latter reflected the build-up of domestic imbalances, evident in the incompatibility of rapid wage growth with sluggish gains in productivity, strong credit expansion and asset bubbles. Capital inflows led to an unsustainable accumulation of private sector debt in countries with current account deficits, while large current account surpluses, especially in Germany, reflected structural weaknesses in domestic demand. Such imbalances are a source of concern in a monetary union since the single monetary policy cannot address country-specific differences.

More worryingly, the adoption of the euro seemed to reduce the political will in some countries to pursue much needed reforms, for instance to open up labour and product markets to competition and reduce costs for businesses, thereby raising the growth potential of their economies. This was mostly evident in the failure to reach the targets set in the Lisbon Strategy.

The single market was already under pressure even before the onset of the crisis, as shown by the opposition to the proposed liberalization of cross-border takeovers and to the opening up of the services sector to EU-wide competition. According to Business Europe, the pan-European employers' association, impediments to the free movement of labour, capital, goods and services have cost businesses between 2% and 15% of their turnover.[6]

Against this background, it should be easier to distinguish between the euro as a currency and the problem of financial stability in the euro area. The latter has been undermined by mismanagement at the political level. Helmut Schmidt, a former German Chancellor, expressed this view in much stronger language last October at a farewell event for the President of the ECB, Jean- Claude Trichet, when he said, '*All the talk of a so-called "euro crisis" is just the idle chatter of politicians and journalists. What we have, in fact, is a crisis of the ability of the European Union's political bodies to act. This glaring weakness of action is a much greater threat to the future of Europe than the excessive debt levels of individual euro area countries*'.[7]

Sub-prime mortgages, the collapse of confidence and the global financial crisis

It is indeed arguable that in a pre-2008 world of sustained economic growth, the euro area's debt problem would have been manageable given time and the adoption of corrective policies prescribed under the SGP's corrective arm. But, as I noted in my introduction, a number of unfavourable developments have intervened to magnify that problem immeasurably.

It all started in 2008 with the eruption of a global financial crisis of unprecedented proportions. It is now clear that risks had been building up over a number of years. Some derived from the fact that corporate governance, risk management, market infrastructures for derivative products as well as supervisory practices and regulatory frameworks had not kept pace with the process of financial innovation. Others have been associated with an overly accommodative monetary policy at the global level, particularly in the United States.

The initial trigger of the crisis was the securitisation of sub-prime mortgages and the associated *originate and distribute* model. These structured products found ready buyers, but there were significant misaligned incentives underlying the model: there were manifest conflicts of interest; originators and brokers had limited interest in ensuring continued monitoring of these products; and credit ratings were inflated, conveying a false sense of security about products that proved to be highly toxic. A euphoric bubble thus developed, based, in Alan Greenspan's words, on '*the complexity of the interactions of asset markets and the economy*', and which concealed a massive global under-pricing of risk.

Market participants seem to have been aware of the growing risks, but were unwilling to retrench. You might recall Citibank's Chuck Prince's memorable words during the onset of the crisis that '*as long as the music is playing, you've got to get up and dance. We're still dancing*'. Market players failed to appreciate the speed at which demand could evaporate and risk aversion could increase. This soon resulted in record-high risk premia, seized-up interbank markets, acute liquidity and credit shortages and bank failures. As banks sought to restructure their balance sheets, the cost of financing rose and credit standards tightened such that borrowers found it increasingly hard to obtain finance. The resultant contraction in private consumption and investment produced a sharp decline in world trade. All these factors helped to push major economies, including that of the euro area, into recession.

But perhaps the largest single casualty, and the one with the most far-reaching consequences, was confidence. This development has been cogently described by the former Group Chairman of HSBC Holdings plc and now a minister in the British Government, Stephen Green, in the introduction to his recent book "Good Value". He recalls his thoughts one day in April 2008 at a conference on the shores of Lake Como against the background of an unfolding global financial crisis. He describes that time as one of those moments in history when it seems as if the tectonic plates are shifting, striking at the roots of what we had taken for granted for a quarter of a century. Green wrote, *'There has been a massive breakdown of trust: trust in the financial system, trust in bankers, trust in business, trust in business leaders, trust in politicians, trust in the media, trust in the whole process of globalization – all have been severely damaged,..*[8]

The policy response, risk aversion, speculation and the sovereign debt crisis

In response to the crisis, governments adopted aggressive measures, including fiscal stimulus packages, bank recapitalisations and the provision of government guarantees, while central banks injected huge amounts of liquidity. This unprecedented fiscal and monetary policy intervention was necessary to avoid a financial meltdown and an economic depression. The by-product, however, was a sharp increase in public debt, with the International Monetary Fund (IMF) describing the situation as '*wartime debt, without a war*.'[9] More importantly, financial markets – which had encouraged and financed government rescue packages at the time - became increasingly tense and volatile, and started to question the sustainability of the debt that had been incurred in the process.

This scenario is currently being played out in a number of euro area countries, especially those that are highly indebted and depend on foreign investors to finance their budget deficits and debt rollovers. They are discovering that the discipline of the market is implacable. We have indeed been observing a perverse dynamic involving institutional investors, particularly bond fund managers, analysts and credit rating agencies, whose outcome has been a self-fulfilling prophecy of a progressive widening of yield spreads and ratings downgrades in a mutually reinforcing cycle.

One of the more glaring examples of this unusual behaviour was the downgrading of Portugal last summer by one rating agency just when that country had started to implement a medium-term adjustment programme negotiated and agreed with the Commission, the ECB and the IMF. On an earlier occasion another agency reduced its rating for Greece three days before the agreement with the IMF was concluded, without knowing the contents of the adjustment programme. Such decisions only serve to undermine investor confidence even further.

Heightened investor risk aversion, however, whatever its origins, cannot alone explain certain market behaviour. Speculation has also played a part. The deregulation of financial institutions, which started in the United States in the 1980s, combined with the development of complex structured products and reward systems for managers and traders that prioritized short-term profits created favourable conditions for financial speculation to become entrenched in the banking sector. It seems legitimate to argue, for example, that the debt crisis in Greece, a country that accounts for just about 2% of the euro area GDP, would not have become a threat to the euro had it not been the object of a speculative attack by institutions from outside the euro area.

The fact remains, nevertheless, that markets have proved more powerful than governments, a reality that the latter, however, have been reluctant to acknowledge. They are exploiting a weakness that Otmar Issing, the architect of the ECB's monetary policy, had already identified in his 2008 book "The Birth of the Euro". Issing observed that '*The economies of the Member States still have some way to go to satisfy the conditions necessary for monetary union to function properly. The political courage at the beginning needs to be complemented by the resolve to pursue the necessary reforms.....Fiscal policy has yet to demonstrate convincingly its full compliance with the self-imposed rules of the Stability and Growth Pact.*'[10] The situation has since deteriorated to the point that the markets are determining both the duration and the composition of governments.

The way forward: – a political solution

To conclude, therefore, it would appear that an eventual solution to what has become an existential crisis for the euro is likely to lie elsewhere than in the workings of the common currency itself. As I have tried to show, the monetary dimension of EMU has been implemented with relative success. But that, although necessary, is not sufficient. As the late lamented Tommaso Padoa Schioppa, one of the founding members of the ECB's Executive Board and a passionate believer in the European project, reminded us in his 2004 book, "The Euro and its Central Bank", '*Through history the strength and success of a currency have been closely related to the strength and success of the economic, social and political entity of which it was an expression, and not just to the skills and professionalism of its central bank.*'[11]

The challenge we face today, therefore, is how to cope with the absence of a full political union. However, since the achievement of deeper European integration is a slow-moving process and, as we are reminded daily, the financial markets are impatient and unforgiving, the priority should be to take all possible steps to shore up investor and consumer confidence. It is necessary to advance rapidly on all fronts.

First, a strong commitment by governments to achieve balanced budgets and to implement structural reforms, backed by the announcement of specific measures to do so, would lay the basis for improved competitiveness, job creation and sustainable growth. This is vital for if the nominal growth rate does not exceed the interest rate on the debt, it is not possible to ease debt burdens. This thinking underlies the approach already taken in Ireland and Portugal and soon to be adopted by Greece, Spain and Italy. This time around, compliance is to be ensured through stricter monitoring by the Commission.

Reconciling reforms and lower debt ratios with growth and equity under current global conditions, however, is an impossible task. Fiscal austerity will further compress economic activity in the short term and, if protracted, is likely to prove socially and politically unsustainable. Demand in these countries, therefore, needs to be supported by a symmetrical fiscal stimulus in the surplus countries and a more accommodative stance by the ECB.

At the same time, markets need to be persuaded that liquidity problems will not become solvency problems. This requires the urgent implementation of G20 and EU decisions already taken with regard to such issues as economic governance, the regulation and supervision of banking systems, the recapitalization of banks and more transparent rating agency behaviour.

To give but one example, it took more than a year for EU leaders to decide to make available the full guarantee amount of the bailout fund, the EFSF, for indebted countries. A further month has passed since the EU summit agreed on leveraging the resources of the fund by a factor of up to four or five and still the fund is not fully operational. The markets are not convinced by words. Statements of intent must be backed by concrete actions if the system is to be protected against further contagion.

The current political stalemate on the way forward, moreover, gives the impression of Europe's leaders being in denial of the fact that no country is immune to the risk inherent in the crisis. The failure of last week's German bond auction to attract enough buyers should have made this clear. The risk is a common one and must, therefore, be carried collectively through the creation of a credible backstop mechanism for the debt mountain. This could take the shape of Eurobonds, allowing an expanded EFSF to buy bonds in the secondary market or creating a Redemption Fund. Denying the need for such a backstop stands in stark contrast to repeated statements that everything will be done to defend the euro. This inconsistency only serves to undermine market confidence even further.

It is not enough, therefore, to pay lip service to the principle of solidarity. The strong must help the weak, not only because this is one of the fundamental values upon which the EU is built, but also because it is in their own interest. It needs to be better understood that, given the high degree of economic and financial interdependence in today's world, the survival of the Union and of the euro is in the interest of each member.

Finally, this also applies to those countries, mainly outside the euro area, who argue against further European integration. They would do well to look beyond narrow national interests and take a longer-term view. Europe is shrinking and ageing. It is estimated that by the middle of this century we will account for only about 7% of the world's population and 10% of global value added. Viewed in this perspective, the current crisis represents a threat not just for the euro, but indeed for the economic wellbeing of many future generations of Europeans.

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About the Institute

The Institute for European Studies is a multi-disciplinary teaching and research Institute within the University of Malta. It runs an evening Diploma course, as well as full-time courses leading to the Bachelor of European Studies degree and to qualifications at MA and PhD level. Each year Maltese and international students enrol in its degree programmes, and through the ERASMUS Programme it offers a number of student and staff exchanges with universities and institutions of higher learning abroad. All of the Institute's courses are fully in line with Bologna Process guidelines.

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