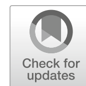
The End of Euro



Miroslav Prokopijević

> *I think within the next 10 to 15 years the eurozone will split apart.*
>
> Milton Friedman, according to: London, S. 2003. Milton Friedman. Lunch with the FT, Financial Times, June 06.

Abstract Euro was introduced to extend and strengthen the euro-integrations, but it might in turn blow them up. There is neither an econometric model nor conclusive inference to prove that euro and eurozone, as we know them, will disappear. Nevertheless, construction problems, misfortunate political decisions in monetary matters, breach of fundamental rules of the game, and their poor enforcement had created and strengthened incentives working against the survival of the zone. In order to survive, the eurozone needs to address three problems. First, who is going to pay debts of troubled countries? Second, how to keep fiscal discipline in the eurozone in order to avert another debt crisis? Third, how to regain competitiveness, not only in the troubled eurozone countries but in the whole EU? For now, the eurozone has partial answers to the first two questions, but it is short of a comprehensive and viable solution. A demise of euro and eurozone seems to be a setback to nanny state and a step toward getting rid of it in Europe.

Keywords Euro • Eurozone • Debt crisis • Mismanagement • Social welfare state

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1 Problems Rooted in History

The euro was launched in 1999 in order to extend and strengthen the European integrations. It is said that one market needs one currency. That, naturally, does not hold, since common market may function better with different currencies, allowing mutual exchange rate adjustments, than with only one that excludes such an option. The truth is that the introduction of the euro ended currency fluctuations for currencies in the basket, fostered trade inside the zone, and reduced transaction costs. But it also brought some new problems. One currency is not a good solution for different economies because they move with the different dynamics and need different monetary policies. Countries entering the eurozone have lost the main instrument of adjustment, currency depreciation/appreciation. Monetary unstable country members have obtained additional security, and they have started to borrow under artificially favorable conditions, which has caused problems with excessive spending, while risks were shifted to the eurozone as a whole. Despite apparent problems with the single currency, the euro was considered as a vehicle of the European integrations. Nobody politically influential among European political nomenclature dared to confront the introduction of the euro and the creation of the eurozone.

To have qualified for the eurozone, countries needed to satisfy five conditions, and these were related to the inflation rate, budgetary balance, public debt, currency fluctuations, and long-term interest rates. The criteria were formulated in a way that would allow both monetary stable and inflationary currencies to pass the test. Although only three countries (Finland, France, and Luxembourg) satisfied all five conditions during the 2 years of qualifications in 1997 and 1998, 11[1] out of 15 European Union (EU) countries became members of the zone in 1999. Greece "qualified"[2] in 2001, while Sweden, the UK, and Denmark opted out. The euro came in circulation in 2002, and some of the EU newcomers have since become new eurozone members—Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014, and Lithuania in 2015. At the beginning of 2016, the zone encompassed 19 out of 28 EU member states.

The euro is the largest monetary experiment in history. It never happened before that 11 countries with 330 million inhabitants covering more than half of Europe abolished their national currencies and accepted a single newly created unit. Experiments need to pass the test of time. Hopes of the euro among European politicians were bright and high, while the voters in the member countries were divided, some even opposed. For example, 70% Germans preferred *Deutschemark* to euro at the time of its introduction.[3]

[1] Austria, Belgium, France, Finland, Germany, the Netherlands, Ireland, Italy, Luxembourg, Portugal, and Spain.

[2] The EU inspection found out in 2005 that Greek governments have cheated about the figures related to their budgetary balance 1998–2004.

[3] With the introduction of euro, 68% of Germans were "unhappy" and 3% "very unhappy." Cf. Eurobarometer (2002, p. 74).

Leading monetary economists of the time were split over euro's chances. Robert Mundell strongly supported the monetary integration despite the fact that it did not represent "an optimal currency area," as he has depicted it. It was expected that labor immobility on the EU market may cause some socioeconomic strains in the zone. Never minded, he wrote: "The more countries join the bloc the greater will be the chance of success. Failure to go forward would be an awesome disappointment to those who see European Monetary Unification as the best catalyst for a stable economic and political order on the continent."[4] Milton Friedman led the euro-skeptics that prevailed among famous monetary economists (like Allan H. Meltzer or Martin Feldstein 1997) of that time. He repeatedly said that one currency for quite different economies is a bad solution, that it prevents necessary trade adjustments, that a monetary union requires its fiscal equivalent, and that the first large crisis will be a real test for the new currency.[5] European economists by and large supported the birth of the new currency, except the Germans, who were deeply divided.[6]

From the very beginning, the euro was more of a political than economic project, and this may be supported with several facts. Only three countries passed the required criteria, while 11 were allowed to join the currency union. Belgium and Italy ran public debts around 120% of their respective GDPs, exceeding double the allowed limit of 60%, and the European Monetary Institution, a predecessor of the European Central Bank (ECB), recommended that they needed to stay out. However, the European Council, a body consisting of heads of states or governments of the EU member states, overturned that recommendation by saying that it would undermine the euro and the integrations if the founders of the EC would be excluded from the eurozone. Nearly all countries have used "creative accounting" to reduce their deficit and debt in order to fit the membership criteria. It was a political decision to tolerate this practice. The optimism of European politicians in the mid-1990s concerning a great future for the euro indicates the fact that sanctions were not initially established for violation of the eurozone's five criteria. Only later

[4]Mundell (1997, p. 17).

[5]Antonio Martino (2008) has collected a number of Friedman's elaborations on the euro.

[6]The majority of German economists, including some famous names like Hans Werner Sinn, were in favor of the euro at the time of its inception. However, a group of 155 German influential economists wrote a petition against the introduction of a common currency, and later on brought the German government before the German Constitutional Court in Karlsruhe, but have lost the case. German economists pointed out in the petition that the euro came prematurely and that a single currency requires a larger liberalization in the labor market (to offset inflexible exchange rates) and structural reforms to enhance competitiveness and add: "In spite of an unusually low level of interest rates, hence reduced costs of debt service, and in spite of numerous examples of creative accounting, the core countries have not succeeded in reducing deficits markedly and sustainably below the 3% reference value. Moreover, the average debt ratio of the member states has not come down since 1991 but has risen by 15 percentage points. As a result, it now exceeds the 60% reference value of the Maastricht Treaty by a large margin. This is contrary to the spirit of the treaty." (Norman and Münchau 1998). At the site: http://www.international.se/9802brdpr.htm (accessed January 5, 2012).

on and under German pressure was the *Growth and Stability Pact* enacted in 1997, which sanctioned the violation of the budgetary limit of 3% of GDP, but the violation of the four other criteria was free of fines. Even the fine for the violation of the budgetary rule was rather symbolic—a maximum of 0.5% of the country's GDP. Does it make sense to punish a country with the amount of up to 0.5% of its GDP, if its deficit is 9% instead of allowed up to 3%? A weak punishment policy was also a matter of a political decision. There were 32 cases of budgetary rule violation in the eurozone from 1999 to 2008, and no single government was punished for that. In 2005, the countries exceeding the deficit limit got additional time to settle the matters, with deadlines extended up to 2013, again a political decision damaging euro. That there is something deeply wrong with the eurozone rules and their enforcement, one may conclude from the fact that Germany, a clear example of the fiscal discipline during the *Deutschemark* era, appears as a violator of the budgetary rule in all 4 years from 2002 to 2005. These developments mark some cornerstones of internal euro drama in a decade from 1999 to 2009. They were also visible from the outside, although they did not provoke larger upheavals inside the eurozone, and because of that, they have passed unnoticed by many economists, thus staying out of mainstream media. It is a surprise, in the light of eurozone management, that larger troubles had not appeared before.

2 The Beginning of Visible Problems

After 10 years of its relatively quiet existence, at least so for a foreign observer, the euro and eurozone experienced the first larger troubles at the end of 2009. Financial crisis that arrived to Europe from the USA in August 2008 hit banking and real sectors in the European Union and undermined public finances of its member states. Public finances were squeezed between lower revenues caused by the crisis and higher expenditures for state aid to economy (merely banks) and social aid to citizens affected by the crisis. Budgetary debts in the EU countries rose to record levels in 2009, exceeding single-digit numbers in some cases, and public debt reached record levels in a number of the zone's countries.

The very first country strained by these developments was Greece: high yields cut off the country from financial markets, and the politicians from the EU along with eurozone member countries started to think how to help Greece. However, the test of time proved that Greece is not the only problem in the eurozone. The two vital financial indicators, yields on debt service and insurance for deposits in commercial banks, also rose sharply for some other eurozone countries such as Portugal, Ireland, Italy, and Spain. Press promptly launched the acronym PIIGS to designate the eurozone troubled countries. Contrary to Greece, troubles in Ireland and Spain originated in the private sector. Heavy investments in real estate and construction have created the bubble. Financial crisis strongly reduced demand for

new apartments, real estate prices collapsed, and credits became nonperforming, which created holes in the Irish and Spanish banks. The main problem in Italy and Portugal is a combination of stagnant economies (with 15 years average growth rate below 0.4%) and higher public indebtedness. Portugal's public debt moved up 80% when Portuguese yields reached 7% and forced government to ask for financial assistance.

The eurozone political leaders did everything to put the topic off the table. They first rejected to recognize that there are problems. Afterward, they blamed financial markets for countries' debt problems and denied that they do have deeper cause by pointing out that they are temporary and that they are merely liquidity problems. Consequently, they intended to cure troubles with liquidity injections. They initially rejected an IMF involvement into aid arrangements for troubled countries with the justification that this would erode the reputation of the eurozone and EU, since this institution has to deal with troubled third-world countries. European authorities have failed to recognize that decades of bad economic policies have brought the seed of the "third world" back to Europe.

The eurozone leaders were not only ignorant about the cause; they also misperceived the size of the problem. In March 2010, they approved an 110 billion euros aid package to Greece and later on the aid packages to Ireland, Portugal, Spain, and Cyprus. In July 2011, the eurozone leaders recognized that Greece needs more aid and have approved another aid package of up to 130 billion euros to be followed by a third one of 86 billion euros in July 2015. The aid was granted to troubled countries in exchange for austerity measures[7] and—it turned out—rather cosmetic reforms. European authorities have fought the debt crisis in a remarkable way. French and German leaders usually convened the deal letting other eurozone members to follow their agreements. This does not strengthen the rule of law and democracy and it undermines mutual trust.

With the flow of time, the eurozone and the EU policy makers realized that public finance problems are neither temporary nor small. In a response, the EU established the European Financial Stabilization Mechanism (EFSM) with 60 billion euros; the eurozone created the European Financial Stability Facility (EFSF) with 440 billion euros lending capacity and the European Stability Mechanism (ESM) that has replaced the EFSM and EFSF in July 2012. After some hesitation, the IMF was called in to assist in supplying funds for troubled economies of up to 250 billion euros. All in all, that was some 750 billion euros on paper, but less in the reality.

[7]There were also proposals for unconditioned assistance—either by the ECB "purchasing as much public debt as necessary" or by debt issuance on behalf of the EU countries (Uxo et al. 2011, p. 589). —but it is difficult to see the rationale of such ideas. Purring good money behind bad money never worked, and it will not work now.

3 "We Violated All the Rules..."

One of the problems with European assistance to troubled countries was that it needed parliamentary approvals in member states, meaning aid could not be speedily delivered. Financial markets do not wish to please bureaucrats by waiting on the lengthy parliamentary and legal procedures. In order to respond to swift changes on the debt market, the European politicians introduced the European Central Bank (ECB) into the battle for eurozone and euro in different ways: some of the measures were against prevailing EU rules, while nearly all of them were controversial. ECB, an institution that should exclusively have a monetary responsibility, was dragged into the fiscal sphere. Among the measures employed by the ECB were low interest rates, liquidity supplies, bond purchases, and "quantitative easing."

First, in 2010, the ECB has reduced interest rates to or close to zero,[8] following similar moves by the FED and nearly all other relevant central banks in the world. This move is both legal and legitimate, but it is costly and destructive for (1) savings, (2) investment, and (3) state spending.

1. Zero referent interest rates imply low deposit interest rates and this primarily undermines banking savings, but secondarily it hits adversely savings in all forms. It leads over time to a huge waste of individual and firms' funds. For example, a person saving for pension that gets 1% instead of 5% interest has to accept a 32% cut in their pension after 10 years and 54% cut after 20 years. This cripples even higher pensions turning pensioners into beggars. Lower savings means less capacity for credit activity, and this in turn implies lower economic activity.
2. Current low or even negative interest rates provide cheap credits, and with them many businesses seem to be profitable although they would not be with a higher, say normal, interest rates and more expensive credits. Many businesses that look profitable now will collapse with the raise of interest rates. In result, there will be a wave of bankruptcies when the ECB one day normalizes interest rates, which again will lead to a waste of resources and to a sharp rise of unemployment rates and a declining economy.
3. Low interest rates pour money into public spending worsening deficit and debt, thus sending the wrong signal that there is a financial solution for larger state spending without reform. It enlarges the heap of debts and relieves countries of necessity for structural reform to enhance competitiveness.

Second, the ECB was encouraged by the European executives to buy bonds of the troubled eurozone countries, and this way state debt papers passed from private to public hands. Nobody asked voters are they in favor of such a policy. The Outright Monetary Transactions (OMT) program is designed for unlimited purchases of government bonds issued by vulnerable countries. This is against the original ECB Statute, according to which the ECB is allowed to buy liquid bonds

[8] Deposit facility was even negative (−0.30%).

only. Greek, Portuguese, and similar bonds hardly may be considered other than junk, and the ECB has accumulated more than 200 billion euros of such "papers" at the end of 2011.[9] If not redeemed by the countries in question, these bonds need to be paid back by the eurozone members, according to the participation in the ECB reserves.

Third, the ECB provided excessive liquidity to weakened and shattered European banks. It is one thing when it does this in a routine way with smaller amounts for daily operations, which is perfectly legal, and it is quite another thing when it supplies commercial banks with huge amounts in a country from which deposits and money systematically flee for years toward safer destinations.[10] Such an assistance is illegal. The EU treaties prohibit[11] financial assistance to member countries, with a temporary exception for major natural disasters. Systemic or long-lasting help to countries for fiscal or other mismanagement is excluded.

Fourth, the ECB launched the first "quantitative easing" (QE) of over 1000 billion euros at the end of 2011 and at the beginning of 2012. The second QE was launched in March 2015 and extended to 2016: it consisted of buying state debt papers for 60 billion euros[12] per month, with the expected total of 1600 billion euros. By December 2015, the stimulus had reached 680 billion euros.[13] Even this huge infusion of liquidity had not brought the EU economies out of their nirvana.

All in all, the measures of the ECB were intended to prevent market forces from punishing bad state and private managers for mismanagement of their respective finances. Some of these measures were illegal from EU legislation's point of view. Some were legal, but very costly and harmful, as it is shown above. Christine Lagarde, the French minister of finance at that time, confessed "dirty works" frankly and directly: "We violated all the rules because we wanted to close ranks and really rescue the eurozone."[14] Such practices are usual in a banana republic, but they are a tragedy for a club of countries that is considered decent. Measures that are mentioned above may help reach some temporary policy objectives, but that has nothing to do with the rule of law and the usual monetary policy. They do great damage to the EU's long-run reputation. Despite this fact, the public hasn't seen that any relevant European politician either disagrees or regrets for illegal moves and other consequences of measures undertaken.

The main effect of the ECB and its interventions was that the debt crisis has been stopped for some time. It was not cured, because the main problems—overspending

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[9]The rule is watered down in the meantime to allow purchase of bonds with credit rating from AAA to B− (B minus). Greek bonds are lower ranked from B−, so that the ECB continues to violate the rule.

[10]The emergency liquidity assistance (ELA) for Greek central bank and commercial banks lasted for years and crossed 90 billion euros in 2015.

[11]Maastricht Treaty, Art. 104. The Treaty on the Functioning of the European Union, Art. 125.

[12]It was increased to 80 billion in March 2016.

[13]Fairless (2016).

[14]According to Carney and Jolis (2010).

and lack of competitiveness of some European economies—had not been taken seriously. An acute crisis is transformed into a chronic one. Time that is bought to fix the problem is wasted. The crisis is postponed instead of being resolved, and then sooner or later, it will be back for resolution.

4 Common Denominator

Euro acted as an internal price control allowing internal interest rates to fall in countries where previous expectations of inflation kept those rates high (Greece, Ireland, Portugal, Spain, etc.). Countries that had previously manipulated[15] their currencies, in order to reduce gap in capital accounts, could not do the same with euro, while the need for some such remedy was urgent more than ever. Financial markets perceived all eurozone government bond risks as similar to one another, and spread among bonds was very small. That had lowered interest rates, and the Southern countries of the EU were plunged by capital inflows as never before. Faced with much lower interest rates, governments of the eurozone countries increased their borrowing to finance growing budget deficits that came with larger social programs and more extensive regulation. Capital inflows have inflated economies and have created some bubbles. One of the most destructive consequences of inflation was the rise of labor costs. As I have shown elsewhere, labor costs rose in 1997–2008 in Germany by 23.7pp, while they jumped in Greece by 77.2pp, Portugal by 40.0pp, and Spain by 54.7pp.[16] What troubled countries required in such a situation was exactly the opposite—disinflation and lower labor costs. Of course, higher labor costs worsened already bad competitiveness, current account deficits soared, and countries desperately borrowed in order to offset them. The game had developed for a while until financial markets started to doubt certain countries' abilities to repay debts.

The culture of dependency from state flourished and it fed the ideal of "capitalism with human face." Politicians used surpluses to please the interest groups and "buy" votes, instead of cutting on taxes and state expenditures. Private sector also enjoyed lower interest rates, which led in some countries to high investment rates and inflation, i.e., bubbles in areas like real estate, construction, labor, some services, and stock exchange. Financial markets did not immediately raise interest rates for countries with rapidly increasing debt to GDP ratios despite the increased risk associated with this pattern of fiscal performance. Credit rating agencies were even slower and less useful in assessing and signaling fiscal risk in such countries. They were capturing fat fees from clients (countries) rather than closely following market developments and providing reliable credit ratings.

[15] Cf. Di Nino et al. (2011).

[16] Prokopijević (2010, p. 380).

Table 1 Current account balance, annual data in % of GDP

Country	2008	2009	2010	2011	2012	2013	2014	2015F
Belgium	−1.0	−1.1	1.8	−1.1	−0.1	−0.2	−0.2	1.8
Germany	5.6	5.7	5.6	6.1	6.8	6.4	7.1	8.7
Estonia	−8.7	2.5	1.8	1.4	−2.5	−0.1	1.1	1.6
Ireland	−5.8	−4.2	−0.8	−1.2	−1.6	3.2	3.7	5.9
Greece	−15.1	−12.4	−11.4	−10.0	−3.8	−2.0	−2.1	−1.0
Spain	−9.3	−4.3	−3.9	−3.2	−0.2	1.5	1.0	1.4
France	−1.0	−0.8	−0.8	−1.0	−1.2	−0.8	−0.9	−1.3
Italy	−2.9	−1.1	−3.5	−3.1	−0.4	0.9	1.9	2.2
Cyprus	−15.7	−7.8	−10.2	−4.0	−5.6	−4.4	−4.5	−3.5
Latvia	−12.3	8.1	2.3	−2.8	−3.2	−2.3	−1.9	−1.8
Lithuania	−13.3	2.1	−0.3	−3.9	−1.2	1.5	3.6	−0.8
Luxembourg	7.7	7.4	6.8	6.2	6.0	5.8	5.4	4.3
Malta	−1.1	−6.6	−4.7	−2.4	1.3	3.7	3.0	2.0
Netherlands	4.1	5.8	7.4	9.1	10.9	11.1	10.7	10.5
Austria	4.5	2.6	2.9	1.6	1.5	2.0	2.0	2.6
Portugal	−12.1	−10.4	−10.1	−6.0	−2.0	1.4	0.6	0.5
Slovenia	−5.3	−0.6	−0.1	0.2	2.6	5.6	7.0	7.0
Slovakia	−6.5	−3.5	−4.7	−5.0	0.9	2.0	0.1	0.0
Finland	2.2	1.9	1.2	−1.8	−1.9	−1.7	−0.9	−1.1

Source: Eurostat. Current account 2008–2014; EC 2015, forecast http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip011_en.pdf (accessed November 26, 2015)

Rather than lower credit rating, the crisis had stopped the inflow of capital[17] into troubled countries through private channels, i.e., via banks. Capital inflow was vital for these countries in order to cover deficits on their current accounts and public finances. And they all run significant deficits that have deteriorated after the introduction of euro, reflecting declining competiveness. From two problems—current account and public debt—it turned out that current account is smaller.

Current account of many eurozone countries started to deteriorate after 2007, and it emerged a worry how to finance it.[18] Current account deficit was very high in 2008–2011 in Greece, Spain, Italy, Cyprus, Malta, Portugal, and Slovakia—merely in troubled countries (Table 1). Difficulties to obtain capital via borrowing and austerity measures along several recent years have first reduced deficits in these countries and in 2013–2014 have transferred them into current account surpluses in Ireland, Spain, Italy, Malta, Portugal, and Slovenia. Deficits existed in Greece and Cyprus but were much lower than before. Contrary to what H. W. Sinn stated, current account is not a problem for now, although it was some years before.

A more difficult question is how to finance public debt on its own. Figures suggest that in recent years, budgetary balance has improved, while public debt has worsened (Table 2).

[17]It is sometimes called "sudden stop"; see Baldwin and Giavazzi (2015, p. 24).

[18]See Sinn (2014, p. 6).

Table 2 Budgetary balance and public debt in the eurozone

	Deficit/surplus					Debt				
	2011	2012	2013	2014	2015F	2011	2012	2013	2014	2015F
Belgium	−4.1	−4.1	−2.9	−3.1	−2.7	102.2	104.1	105.1	106.7	106.7
Germany	−1.0	−0.1	−0.1	+0.3	+0.9	78.4	79.7	77.4	74.9	71.4
Estonia	+1.2	−0.3	−0.1	+0.7	+0.2	5.9	9.5	9.9	10.4	10.0
Ireland	−12.5	−8.0	−5.7	−3.9	−2.2	109.3	120.2	120.0	107.5	99.8
Greece	−10.2	−8.8	−12.4	−3.6	−4.6	172.0	159.4	177.0	178.6	194.8
Spain	−9.5	−10.4	−6.9	−5.9	−4.7	69.5	85.4	93.7	99.3	100.8
France	−5.1	−4.8	−4.1	−3.9	−3.8	85.2	89.6	92.3	95.6	96.5
Italy	−3.5	−3.0	−2.9	−3.0	−2.6	116.4	123.2	128.8	132.3	133.0
Cyprus	−5.7	−5.8	−4.9	−8.9	−0.7	65.8	79.3	102.5	108.2	106.7
Latvia	−3.4	−0.8	−0.9	−1.5	−1.5	42.8	41.4	39.1	40.6	38.3
Lithuania	−8.9	−3.1	−2.6	−0.7	−1.1	37.2	39.8	38.8	40.7	42.9
Luxembourg	+0.5	+0.2	+0.7	+1.4	0.0	19.2	22.1	23.4	23.0	22.3
Malta	−2.6	−3.6	−2.6	−2.1	−1.7	69.8	67.6	69.6	68.3	65.9
Holland	−4.3	−3.9	−2.4	−2.4	−2.1	61.7	66.4	67.9	68.2	68.6
Austria	−2.6	−2.2	−1.3	−2.7	−1.9	82.2	81.6	80.8	84.2	86.6
Portugal	−7.4	−5.7	−4.8	−7.2	−3.0	111.4	126.2	129.0	130.0	128.2
Slovenia	−6.6	−4.1	−15.0	−5.0	−2.9	46.4	53.7	70.8	80.8	84.2
Slovakia	−4.1	−4.2	−2.6	−2.8	−2.7	40.5	40.1	41.0	41.6	52.7
Finland	−1.0	−2.1	−2.5	−3.3	−3.2	48.5	52.9	55.6	59.3	62.5
Eurozone	−4.2	−3.7	−3.0	−2.6	−2.0	86.0	89.4	91.1	92.1	92.2
EU27/28	−4.5	−4.3	−3.3	−3.0	−2.5	81.0	83.8	85.5	86.8	87.8

Source: Eurostat. General government balance and public debt. EC (2015) forecast. http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip011_en.pdf (accessed November 26, 2015)

Budgetary balance in the eurozone countries apparently improved: in 2011, five countries only were below 3% limit (Germany, Estonia, Luxembourg, Malta, and Austria) and in 2015 15 of them. In 2015, it was expected that four countries (Greece, Spain, France, and Finland) exceed the limit, with the deficit of the eurozone as a whole sliding from −4.2% in 2011 down to −2.0% in 2015. Public debt was in a worse state, where the five tiny countries (Estonia, Latvia, Lithuania, Luxembourg, and Slovakia) were obeying the 60% limit, and other 14 members were violating the rule. The number of countries with the debt exceeding 100% of GDP has doubled in 2015 compared to 2009. It went up from three to six (Spain, Cyprus, and Portugal joined Belgium, Greece, and Italy). Especially worrying was the fast rise of deficit in 2011–2015 in Spain (from 69.5–100.8%), Cyprus (65.8–106.7%), Greece (172.0–194.8%), Portugal (111.4–128.2%), and Slovenia (46.4–84.2%), and moderately fast rise in France (85.2–96.5%) and Italy (116.4–133.0%).

Ireland is the only vulnerable country that managed to reduce its huge public debt, and it started decreasing from 2013 on. Among other eurozone countries exceeding the 60% limit, deficit has been falling in three of them—Germany, Cyprus, and Malta. The four largest eurozone countries (Germany, France, Italy, and Spain) are in breach of 60% rule. Because larger countries do have much more influence on what happens in the zone, the fact that smaller countries obey the rule plays no role, since their impact on eurozone’s general fiscal condition is negligent.

It is important to notice that these results in public finances have been achieved with the help of the ECB. Low interest rates and stimuli have increased the capital on market, and a significant chunk of it ended in state bonds. Debt service became dramatically cheaper. For example, German 10-year bonds in recent months (2016) promise yields in the range 0.2–0.8%, while they were 3.2–5.5% in the period 2000–2009. Spanish and Italian 10-year debt papers yield 1.4–2.0% now, while yields moved similar to the German before 2009. The era of cheap money cannot last forever, and when the FED, ECB, and other larger central banks start to raise interest rates and to withdraw liquidity brought by stimuli, debt service will be more costly, with rates returning toward levels prior to 2009. This will increase pressure on public finances, not only of vulnerable countries but also of some others that were not counted in troubled before. The risk of default will overshadow several eurozone countries.

The main function of the ECB measures and the EU funds was to supply troubled countries with liquidity and so to replace private borrowing that had stalled after the outbreak of debt crisis in 2009. Missing private capital inflows were replaced in the meantime with public inflows via the ECB and ESM transfers. Capital again flows in the opposite direction of that needed. In usual cases (gold standard, currency board, dollarization), there are no flows of public funds offsetting for decreasing private inflows. Instead, these arrangements dispose over some automatic mechanism that provides adjustment by changing the amount of money, interest rate, credit supply, and the level of salaries. These changes are induced by changing level of inflows, and after adjustment takes part, private inflows resume according to new realities.

The eurozone—and this is its crucial construction failure—does not possess such a mechanism, the adjustment never happens, countries miss private inflows, and for that they are dependent on public transfers. Instead of market mechanisms, flows are directed from political institutions and nonmarket funds (European Commission, ECB, IMF, ESM). It created exactly the situation that is intended to be avoided—of countries dependent on permanent assistance, i.e., of countries living at the expense of others. The only way to avoid this self-defeating outcome would be a deep structural reform in troubled countries—inside or outside of the eurozone. However, reforms are off the agenda because they are politically costly, inspire social turbulence, and work to dissolve the prevailing model of "capitalism with human face."

The crisis management of the eurozone was bad. Instead of cutting costs as much as possible, allowing countries to default, to step out of the zone, to reintroduce their national currencies, and to devaluate 30–70% and conduct necessary reforms, the EU and eurozone—frightened by mass contagion and systemic risk—started the operation that is very costly and that does not produce healthy condition. Costs of treatment are huge both directly (funds from EU, IMF and eurozone, operations of the ECB) and indirectly (worldwide loss in savings, miss-investment in businesses that would be not profitable with normal monetary policy, prolonged crisis, and lost decade(s)). When the crisis one day returns, its resolution costs are going to be much higher than a cut at the beginning of crisis in 2009. By providing assistance, the eurozone bought time, but it was wasted rather than used for necessary reforms. When bad developments erupt, European politicians start buzzing about reforms, but after the crisis abates, the reform talks evaporate. In a word, in order to buy time, crisis management accumulated huge costs, which was wasted, and the crisis is still around. European politicians never gained control of the situation, despite unconstrained action (breach of the rules) and frequent meetings.

5 Likelihood of a Solution

If the eurozone is to survive, it needs answers to at least three questions. First, who is going to cover debts of troubled countries? Second, how, in a credible way, to prevent the outbreak of another similar debt crisis, i.e., how to keep the fiscal and monetary discipline in the eurozone? Third, and the most important, how to regain competitiveness in the troubled countries and enhance it in the rest of the EU? Adequate answers to all three questions represent an appropriate response to the eurozone debt crisis. Failure to deliver and implement answers to any of three questions implies that the crisis will remain open and that, sooner or later, it is going, first, to undermine and thereafter destroy both the eurozone and the EU. Europe's political class hitherto offered two partial answers for the first two questions (financial assistance and fiscal pact), while the third one remained unanswered.

(1) Debts Response to the first question was the financial assistance to troubled countries (Greece, Cyprus, Ireland, Portugal, Spain) in exchange for austerity measures. Assistance included different fund sources (EFSM, EFSF, ESM, IMF), purchases of bonds by the ECB, low interest rates, support for banks, cash supplies from the ECB to commercial banks in vulnerable countries, and the long-term refinancing operation (LTRO). The result of all these interventions was that troubled countries were kept afloat, but for some of them without being able[19] to appear on its own on the financial markets, and without settling their problems for longer if not indefinitely (with the exception of Ireland).

Current European funds are considered insufficient for helping economies of larger size. If the assistance to Greece, Cyprus, Ireland, and Portugal—countries representing 8% of the EU economy—approached 500 billion euros, an assistance to larger countries like Italy and Spain, representing more than 20% of EU economy, would require much more. The EU and eurozone can probably increase protective funds up to 1000 billion euros, but they can hardly get up to 1500 billion euros, what is considered necessary if Italy and Spain together ask for assistance in addition to some out of the four countries already under the program. With the number of countries in need rising, the number of countries able to provide aid will be declining, and their burden will become heavier.[20]

Saviors have used the instruments mentioned above. However, optimists may hope for instruments that have not been used yet, like higher inflation, emission of the common European bonds, formation of fiscal union, and direct transfers under eventual fiscal union. Even if used, the question is whether these measures may be effective.

For example, inflation enjoys low acceptance rate in Germany and some other eurozone countries. It distracts economic activity and undermines growth. More important for debt service, inflation reduces the debt burden, but it also reduces income, so that the GDP/debt ratio remains the same before and after the inflation tide. For that inflation seems to be a part of the problem rather than a part of the solution.

Eurobonds would heavily burden more fiscally sound nations, while they would not change bad habits of fiscally weak countries. That would preserve the status quo, enlarge the heap of debts, and make the whole eurozone similar to weak countries.

Fiscal transfers between member countries, be it ad hoc and partial or complete (e.g., under a fiscal union), are even more disputable, especially in the light of fact

[19]For example, Greece and Cyprus. Some other troubled countries (Italy, Portugal, Spain, etc.) borrowed in 2014 and 2015 on financial markets with yields below 2% for 10-year bonds. These very favorable borrowing conditions are possible due to a low interest rate policy by ECB and its other measures. Financial market analysts believe that without these measures, yields for these countries would cross 7% that is considered unsustainable for longer time in the case of stagnant or slow-growing economies.

[20]There is already parliamentary political resistance in several countries providing assistance, like Germany, Austria, Finland, Slovakia, Netherlands, and Luxembourg.

that national[21] transfers that enjoy some advantages over international ones, and have failed. The USA is a fiscal (political) union, but this does not prevent city, municipal, and state bankruptcies. Local and federal government units, without bail-out clause, are forced to return to financial market. This presupposes a reform. Proposal of fiscal union in the eurozone is intended to introduce interstate transfers rather than to foster reform and a return to financial market. More fiscal unity is neither good nor feasible—political readiness for that is missing.

Different populations tend to develop different economic and fiscal habits, as the Austro-Hungary, Czechoslovakia, Yugoslavia, and other multinational countries have demonstrated. These countries failed to develop common fiscal standards for longer, and their fiscal "systems" became a source of disputes as soon as they were established. Fate of these countries advises both against common fiscal policy for the eurozone and EU and large transfers.

In a summary, even if employed, the abovementioned measures can prolong the fight for euro for a few years or so, but at the end the common currency is going to fall into demise.

The question of debt is surrounded by uncertainties. Eurozone's debt pile is growing, and it is not known whether this trend could be stopped and then reversed. Are troubled countries able to return to financial markets after the assistance expires, and FED and ECB increase interest rates, which would make debt service more costly? If German bonds return to their previous usual level of 3–5%, bonds of vulnerable countries will require higher yields for at least 2–3pp, and their debt service will not be sustainable in the light of their stagnant economies. If so, a prolonged assistance will be needed. However, the question is whether there would be those ready to provide it. In 2015, Germany's exposure through different assistance programs exceeded 406 billion euros, an amount larger than country's federal budget.[22] With fiscally sound countries reluctant to further call for assistance, the default of vulnerable countries and the eurozone contagion will be more probable.

[21]Germany has sent more than 1800 billion euros to its provinces in the East in the period of 1990–2010. Transfers have raised salaries in the East above productivity level, which had killed investments and competitiveness and has led to an economic failure of the German East. These transfers were managed by the German administration, which is for sure superior in its performance to the international administration in Brussels. Transfers moved from Germans to Germans, thus cutting off disputes about their desirability; fiscal transfers in the EU would move from one nation to another, feeding disputes among different governments and national elites about reasonability of the operation, and disputes of this type were a seed of dissolution for many multinational countries and units. Fiscal transfers to the East after reunification of Germany was a second failed German attempt to bridge the fiscal and development gap via transfers. The first one is related to the *Finanzausgleichsgesetz* in the 1960s.

[22]The exposure of some other countries on May 8, 2015, was France, 409 billion euros; the Netherlands, 117 billion euros; Austria, 57 billion euros; and Finland, 37 billion euros. Total commitment is 20–40% higher than exposure, depending on country in question. Cf. CesIFO (2015).

(2) Fiscal Discipline When the debt crisis broke out, the European politicians were obsessed with looking for a solution related to the question (1). This is understandable, because if there is not at least a temporary fix for question (1), there is no point in attempting to address the two other questions.

Relating to the second question, creditors demanded that troubled countries cut spending and deficits and implemented austerity measures. However, cuts are not enough to provide a workable fiscal discipline. Financial assistance helps troubled countries to service their usual obligations and buys them time for additional measures. The time bought needs to be used properly, but deeper reform has not arrived yet in any member country. As soon as assistance mitigates suffering in vulnerable countries and averts "systemic risk" for the eurozone, the pressure from the eurozone decreases, and the readiness for reform in troubled country disappears. Austerity[23] is broadly perceived as a remedy, but it alone does not suffice: it shifts an economy to decline; expected increases in state revenues never happen; quite on the contrary, lower economic activity further reduces public revenues; and the country starts sinking deeper into debt rather than escaping out of it. That is a development to be seen from Portugal and Spain via Italy to Greece and Cyprus. Governments getting aid try to avoid painful cuts, and if they pass some reform legislation, it is rather symbolic. Even if they succeed in keeping fiscal discipline in 1 year, they may easily slip again into heavy breaks in another one. In order to provide financial discipline, some systemic and workable mechanism and its enforcement procedure are needed.

There have been several proposals on how to keep financial discipline floated in Brussels and national capitals with one of them officially accepted in 2011 and named the "fiscal pact." According to its terms, structural deficit[24] of up to 0.5% of GDP is allowed.[25] Structural deficit makes the limit of 3% deficit efficient, because it prevents that a country runs 3% deficit over a whole business cycle. Automatic consequences for countries violating that rule (i.e., 3% deficit) are envisaged unless qualified majority (73% of votes in the Council plus 2/3 of countries) is opposed. The ceiling should be built in into the national legislation, preferably of constitutional nature. National draft budgetary plans are to be sent to the European Commission (at the same time as to national parliaments) and independent fiscal councils monitoring implementation of the rule. In the case of a violation, there are infringement proceedings through the Court of Justice of the European Union.

[23] Among proponents of austerity is Phelps (2012).

[24] The structural deficit is the deficit that remains across the business cycle. It emerges when a government is spending more than a long-term average of tax revenue can bring in. Structural deficit is total government deficit minus cyclical deficit. Cyclical deficit is output gap times elasticity of fiscal balance. Again, output gap is equal to potential (full employment) output of economy minus actual output of economy. Output gap is expressed in % terms difference. Finally, elasticity of fiscal balance captures percentage change in government expenditure net of government revenue per 1% change in output gap.

[25] The following conditions are cited according to EC (2011) at the site: http://ec.europa.eu/europe2020/priorities/economic-governance/graph/index_en.html (accessed February 15, 2012).

Countries violating the budgetary rule need to pay 0.2% of GDP at the opening of excessive deficit procedure, fixed fine of 0.2% in the case of non-compliance with recommendation to correct, and variable fine 0.2% plus 1/10 of the distance between the actual balance and the required one. Public debt needs to be below 60% of GDP or sufficiently diminishing toward 60% of GDP (=reduction of the distance to 60% by 1/20 on average over 3 years). Member states in excess of these limits are to be given strict deadlines to get into the line. Elements of the "fiscal pact" are to be incorporated into EU treaties and national legislations in 5 years. This may turn out to be too late to cure ailing eurozone public finances, but there are several other questions overshadowing recent EU legislative proposals and solutions.

Do existing rules suffice to keep the fiscal discipline? They suffice, but their enforcement is too weak to avert potential offenders. Fines are low, the Commission has to bring offenders to the Court, efficient enforcement instruments are missing, correction time is generous, and sanctions could be abolished through the political process, as it happened before in cases of violation of agricultural quotas or misuse of development funds. All this will encourage offenders rather than constrain them. The rule of 0.5% structural deficit may be built in national legislations, but its enforcement is another issue. Even the Greek officials have rejected vehemently any foreign control over Greek public finances. The eurozone has had 3/60% rules, but they were heavily violated recently, and no state was fined. In order to be deteriorating enough, the financial fine needs to be both automatic and much higher, and the sanctions need to include the suspension of transfers from Brussels' funds and suspension of countries' voting rights in the EU bodies. However, such rules would be difficult to legislate, because too many countries would perceive themselves in the role of the legislation' victim. If a proper penalty policy cannot be established, that is a signal that nobody is counting on it. If there is no fine, anything goes. If anything goes, the end of the game is not far away.

It is hard to believe that eurozone countries will respect deficit rules, when during the last 40 years, some of them never got rid of deficit, as Table 3 shows. Even fiscally responsible countries, like Austria and Germany, have spent 82 versus 78% of their time in deficit. The last time countries like Austria, Greece, and France got surpluses was in the 1970s—more than four decades ago. If deficit culture is so deeply rooted in the eurozone countries, it is unreasonable to expect that this is going to change overnight, because there are legislated limits of 3.0 versus 0.5% (for structural deficit).

It is also hard to believe that the existing rules[26]—say 3/60%—are going to be enforced now, i.e., during the economic downturn, if their enforcement failed in the

[26]Before the rule of "structural deficit" was introduced, there was no guarantee that preserving fiscal discipline is possible, even when obeying the rules 3/60%. If a country keeps deficit slightly below 3%, over two dozen years, it will accumulate a debt of over 60%, even if it was debt-free before. For this, the debt limit of 60% makes no sense, neither theoretically nor in practice. The rule of "structural deficit" limits deficit over business cycle to 0.5% of GDP per year and makes fast accumulation of debt impossible.

Table 3 Percent years of deficit over 1962–2011

Country	Percent	Last surplus
Austria	82	1974
Belgium	96	2006
Germany	78	2008
France	90	1974
Spain	78	2007
Greece	80	1972
Ireland	80	2007
Italy	100	–
Portugal	100	–

Source: Wyplosz Charles (2012, p. 2)

period of economic prosperity, from 1999 to 2008. Enforcement in bad economic times is possible, but unlikely to happen.

In order to adopt a new reliable regulation, it needs to be approved by 28 EU members. This is unlikely to happen, because many initiatives for changes in the treaty regulation failed in the previous years. These regulations were related to more innocent-looking questions than the deficit and debt rules. Even if a miracle happens and the rule is agreed on and written in the EU Treaty and national constitutions, there is a problem of enforcement. Brussels can send neither financial police nor troops to a country whose government violates the budgetary rule. With all that being said, it is difficult to imagine the fiscal discipline lasting for a long time in the eurozone is going to be kept in the future.

(3) Competitiveness While dealing with the European debt crisis, the question of competitiveness was nearly neglected. Both Brussels bureaucrats and national leaders of member countries pay only a lip service to reforms and competitiveness.[27] In order to enhance competitiveness in countries that have lost it, profound changes in several fields are needed. One is related to structural reforms, like removing rigidities on labor market, enhancing competition, opening the market,[28] and generally reducing the red tape. Another is a decomposition of social welfare state and generally a reduction of state costs. Such reforms face vigorous and lasting resistance from interest groups, as one can see from Greece, Spain, Portugal, Italy, etc. Even modest attempts to relax rigidities of the labor market and to cut privileges failed due to fierce resistance of interest groups in question. It seems that measures promoting competitiveness are easier to conduct after countries'

[27]Some official proposals on how to regain it fall short or miss the point, because they assume as given what needs to be achieved: "The restoration of confidence in the future of eurozone will lead to economic growth and jobs." Herman Van Rompuy, President of the European Council, according to Ben Rooney. 2012. "Europe strengthen fiscal ties," March 2. http://money.cnn.com/2012/03/02/markets/european_union_fiscal_pact/index.htm (Accessed on March 4, 2012).

[28]According to the rules, common market is open and free, but reality is different. Countries prevent access to foreign competitors in several sectors, like energy, banking, insurance, transportation, public procurement, and services.

default than in a situation that is relatively normal—when a country enjoys a generous foreign assistance. Default would increase pressure for reform, undermine resistance, and create different solutions[29] and incentives compared to those under foreign assistance. In the latter case, the feeling that painful changes are not necessary emerges, and, if enacted at all, they will enjoy a lukewarm support and will be watered down over time.

How likely is it that European politicians will find a workable solution to all three questions in the appropriate time? Such an outcome is theoretically possible, but not likely to happen. Debt service costs will soar following the normalization of interest rates. Fiscal discipline was never enforced in the eurozone, and the likelihood of profound improvement in this field is low. A huge majority of eurozone economies will continue to suffer from low competitiveness until something changes in social network and interest groups lose the ground, opening a way for a deeper reform. Their transition does not need to be stressful like the one in the Eastern Europe, but "soft socialism" needs to be left behind as an expensive luxury.

Before transition from "soft socialism" to market democracy under the rule of law begins, one will see more efforts that were already seen, such as assistance. It fuels disputes. Divisions among countries are visible, disputes about responsibility manifest more, and proposals for solutions diverge. In critical moments disputes resemble[30] to those preceding the dissolution of Yugoslavia. It starts with a dispute over responsibility for economic downturn and ways of overcoming the economic decline, followed by arguments over debt service, resulting in political divergence and ending in dissolution. The EU is in the phase of debates on cures for economic decline and assigning responsibility. Some confrontations in the EU, for example, on German-Greek axis, are not less passionate and colorful than Serbo-Croatian disputes during the late 1980s, i.e., a few years before dissolution of Yugoslavia.

In any case and whatever scenario (Greek default, Germany fed up from assistance, stalemate in Brussels), the eurozone and the euro-integration, as we know them now, will not be around in not so distant future.[31] Even if eurozone manages to survive around Germany, with countries like Austria, Belgium, the Netherlands, and Luxembourg in, it may last for additional several years or so rather than for a longer period of time. The euro of shorter eurozone is expected to appreciate strongly, reducing exports. As such it would not be in the interest of all these countries. More importantly, different economic dynamics and different habits in public finances, in conjunction with nonexistent single fiscal authority,

[29]For example, a larger reduction of salaries is easier to achieve via depreciation of national currency than via nominal (and real) cut of them expressed in euro, because the later move will face bitter, lasting, and non-abating opposition. A larger cut of salaries, say 30–40%, is practically impossible until the country is a member of the eurozone.

[30]Economist from Slovenia Jože Mencinger was first to draw an analogy between EU and Yugoslavia in his newspaper articles and interviews for the regional press.

[31]There are already popular guides on exit option, cf. Bootle (2012).

will take these economies onto separate paths and first force some country members and not long after nearly all of them to get out of the common arrangement. One monetary standard for different economies is a rigid solution, and countries tend to get out of it. Two recent evidences support this statement. Gold standard from Bretton Woods lasted less than three decades, while the exchange rate mechanism—a precedent of the euro from early 1990s—lasted less than 4 years.

More than 20 years ago, the world had seen the end of the Soviet communism, that is called also "hard socialism," and now the demise of the European soft socialism is to be seen. European nations will go through a painful transition period, partly similar to the one that had been seen in Eastern Europe after the collapse of communism. This change should dismantle the welfare state and strengthen the rule of law and market forces. The situation in the eurozone resembles to what happened under socialism, when losses from wasteful management were covered by borrowing from abroad, until foreign creditors lost faith in repayment, thereafter by the work of mint. Janos Kornai (1980) has argued that communism has failed in economic sense because the budgetary "hard constraint" was missing. Without a constraint there was nothing to stop permanent slide in ever-growing debts and socialization of economic irrationality materialized in ever-growing losses. The case of "soft socialism" is similar to the one seen before, because a "hard constraint" was missing too, allowing excessive spending that fed growing debts.

It is not per chance that the debt crisis and economic crisis emerged in the EU. The story of Anglo-American capitalism that is too cruel and Europe inventing its own model of "capitalism with a human face" has been around for decades. Pro-market economists have coined the term "soft socialism" for such an order.[32] Europeans introduced huge redistribution mechanisms and extended the welfare state to "humanize" the order, but as a consequence of that, the economy suffered from overregulation, high taxes, and expensive products. With massive and different government interventions, protecting indebted governments, firms, and banks that are "too big to fail," the state inhibited market forces. This indicates why anti-market moves and strategies dominate in defending the eurozone. And this explains why the interventionist social welfare state, after the collapse of communism, became the main form of the anti-market order. As in the case of communism, this fight is lost,[33] and one may wonder for how long it will last, how much it will cost, and what additional troubles[34] it will leave behind.

[32]Pejovich (2009, pp. 33–34).

[33]Mises stated in the early 1930s that communism is sentenced to death, but it lasted for six decades more to see its historic end (Cf. Mises 1922).

[34]Cf. Mundel (2000).

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