Europe's Unresolved Crisis

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Abstract The euro crisis has exposed the structural weaknesses of Europe's model of growth and the differences within the region, and has made evident the deficiencies in the governance of EMU. Countries in the euro periphery have been suffering from long-standing fiscal problems, under-performing economies and imbalances, and a widening gap in competitiveness against "core" countries. They face problems which require a combination of urgent priorities and long-term measures. In the immediate future they have to convince markets that their fiscal plans will reduce debt but without a collapse in growth, and to normalise their banks' access to market funding. In the longer term they need to achieve sustainable increases in growth, and to improve competitiveness and their external payments positions. Structural measures to address the long-term challenges of rebalancing the euro economy, dealing with regional growth differentials and supporting GDP growth are necessary for the future survival and stability of the euro. Changes to the governance of the euro are also required so that countries follow policies that are consistent with the requirements of a common currency, and so that the burden of policy adjustment is borne more equitably.

Keywords Competitiveness • Europe • Exchange rate • Sovereign debt crisis

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1 Introduction

Despite Greece's repeated bailouts, Europe's sovereign debt crisis, which began in 2010, remains the biggest threat to the global economy. Rooted in the financial and economic imbalances within Europe, the structural weaknesses of its model of growth and the differences within the region, the crisis has exposed the deficiencies in the governance of the European Economic and Monetary Union (EMU) and shown the limits of its framework of policy cooperation.

The euro crisis did not develop overnight, but incubated over a number of years. Since the EMU's inception, the political nature of European integration has taken priority over economic principles. It has always been clear that Europe falls short of the requirements for an optimal currency area as envisaged in economic theory.[1] A monetary union that was not accompanied by a fiscal union could only succeed by putting in place robust governance and strong rules. Yet for many years rules in the euro area have been disregarded for the sake of politics.

Two of the countries at the center of the sovereign debt crisis, Greece and Italy, were admitted to the single currency union with public debts well in excess of the 60% of GDP limit laid down in the Maastricht Treaty. However, Italy, one of the signatories of the Treaty of Rome in 1957 and one of Europe's largest economies, was deemed necessary to the economic and political success of the euro, and was therefore admitted on the assumption of future fiscal consolidation. Greece's bid for membership came during the preparations for the 2004 Olympics when massive investments had boosted its economic growth. In any event, as it only accounted for approximately 2% of the total euro area economy, Greece was believed to be too small to have any significant impact on the stability of the currency union.[2]

The other countries primarily affected by the crisis—Ireland, Portugal and Spain—were faced with interest rates set by the European Central Bank (ECB) that were inappropriate for the pace of their economic growth and their credit conditions. Monetary policy at the eurozone level was too loose for these countries and needed to be offset by suitable domestic policies, but this did not happen. Instead, credit growth and private-sector borrowing remained excessive, and current account deficits widened, signaling the build-up of large imbalances.

In the aftermath of the collapse of Lehman Brothers in September 2008, most European governments intervened to rescue their banking systems and to support economic growth. As a result, public deficits and debt widened, and Ireland, Spain and Portugal ended up joining the group of countries with long-term public finance problems. For Europe as a whole, the banking crisis morphed into a sovereign debt crisis.

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[1] For a detailed discussion on optimal currency areas, see Mundell (1961, 1963, 1973a, b). In addition, for a discussion on Mundell's work, the euro and optimal currency areas see McKinnon (2000).

[2] Unless otherwise mentioned, the data used in this paper are from the International Monetary Fund's *World Economic Outlook* (IMF WEO), April 2012.

The last two years have seen numerous attempts at the European level to address the crisis. However, as well as taking effective steps to deal with the immediate problems, it is necessary to address the longer-term issues that lie at the origin of the protracted build-up of imbalances within the euro area. In addition, there are significant issues regarding the future governance of the euro area (and the EU as a whole) that need to be addressed if the euro is to survive.

This chapter argues that structural measures to address the long-term challenges of rebalancing the euro economy, dealing with regional growth differentials and supporting GDP growth are required for the future survival and stability of the euro. Changes to the governance of the euro are also required so that countries follow policies that are consistent with the requirements of a common currency, and so that the burden of policy adjustment is borne more equitably.

2 The Critical Outlook for the Euro Periphery

The sovereign debt crisis has widened the divide between European countries that are well adapted to survive and prosper within the monetary union and those that are not. Countries in the periphery with problematic debt positions have seen sharp rises in government borrowing costs since the crisis erupted and at each critical point in its development (Fig. 1). Before January 2010, the periphery countries were able to borrow at a similar cost as Germany. However, the euro crisis has exacerbated fundamental macroeconomic imbalances and eroded market confidence, and therefore significantly increased the risk of sovereign default within EMU. Since Greece agreed a write-down on its privately-held debt, this has spilled over to other countries, such as Spain and Italy, with problematic but not critical positions. Most of all, massive capital outflows from problematic countries into "safe" countries have worsened the already existing imbalances.

Earlier in 2012, following elections in Greece and France, the emphasis in the debate within the eurozone has shifted from "austerity" to "growth". Also the ECB's Long Term Refinancing Operation (LTRO) facility succeeded in stabilizing markets for a while and buying time.[3] Cheap loans with a maturity of 3 years provided by the ECB eased the funding pressures experienced by banks in the single currency area and contributed to a bond rally in early 2012. Italy, in particular, benefited from the LTRO and the austerity plan adopted by the new government led by Mario Monti. But the crisis has continued, as investors concluded that the necessary long-term measures were not being taken at the political level, in individual countries and at the eurozone level.

[3] To support bank lending and liquidity in the euro area money market, the ECB undertook two LTROs with a maturity of 3 years and an option of early repayment after 1 year on 21 December 2011 and 28 February 2012. Take-up by banks totaled over one trillion euros in the two operations.

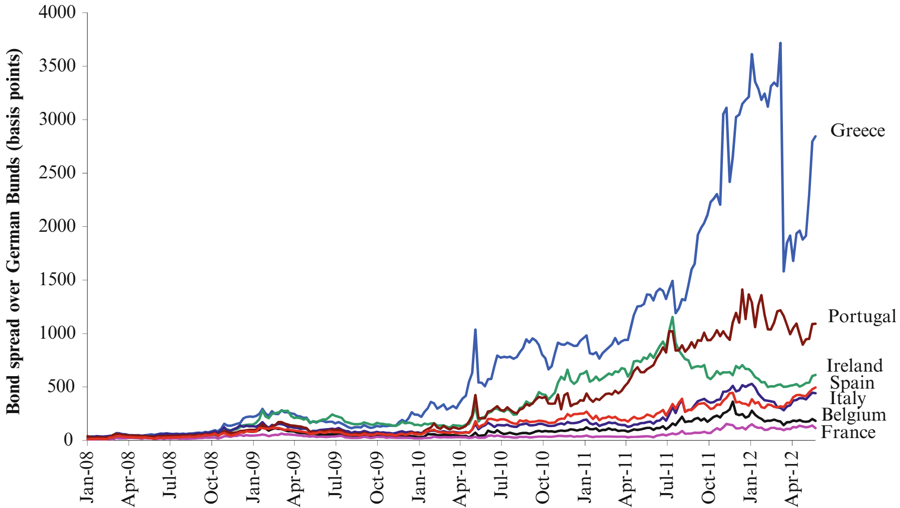

Fig. 1 The cost of government borrowing. Note: Based on 10-year government bond yields. Source: Financial Times

Greece, however, continues to be the major concern despite the bailout package from the EU and the International Monetary Fund (IMF), and a deep "haircut" on private holdings of Greek debt. Its fiscal problems remain grave and are exarcebated by continuing recession. With GDP growth estimated to contract by 5.3% in 2012 and 1.3% in 2013, there is little scope for improvement in revenues, while a further dose of fiscal austerity is not feasible, both economically and politically. Therefore, the goal of reducing Greece's debt to GDP ratio to 120% by 2020 looks very ambitious and more likely unattainable.

3 The Long Genesis of the Sovereign Crisis

In the immediate aftermath of Lehman Brothers' collapse in September 2008, it seemed possible that Europe could escape the worst effects of the global financial crisis. Initially, only those European countries that were exposed through their banking and financial system, such as the United Kingdom, Ireland and Spain, were affected. Excessive credit growth in these countries, fuelled by foreign capital flows, had created imbalances that became unsustainable in the aftermath of the Lehman collapse. When the United States financial and banking system clogged up, foreign capital flows were halted. Struggling parent banks cut back funding to their local subsidiaries through tightened credit or higher costs of borrowing (Subacchi 2011).

As the crisis deepened, more countries were forced to use both monetary and fiscal measures to bail out troubled banks and to support weakening economies. The banking sector was the main recipient of government and central bank money to ensure that credit flows were not frozen and thus avoid a possible banking collapse. Troubled financial institutions were supported via capital injections, guarantees or partial nationalization. Interventions in support of the real economy were also

Table 1 Sovereign debt, Euro area (% of GDP)

Euro area	2007	2011
Ireland	24.9	105.0
Finland	35.2	48.6
Spain	36.3	68.5
Netherlands	45.3	66.2
Austria	60.7	72.2
France	64.2	86.3
Germany	65.0	81.5
Portugal	68.3	106.8
Belgium	84.1	98.5
Italy	103.1	120.1
Greece	105.4	160.8
International comparison		
United Kingdom	43.9	82.5
United States	67.2	102.9
Japan	183.0	229.8

Source: IMF WEO, April 2012

substantial,[4] even in countries such as Germany that were reluctant to use fiscal policy to stimulate their economies.[5]

Fiscal stimulus, alongside falling tax revenues and the impact of automatic stabilizers, resulted in an increase in debt-to-GDP ratios for European countries, from a pre-crisis average of around 61–74% in 2009. The fiscal position of some in the periphery deteriorated even more rapidly owing to a number of country-specific factors. These included high pre-existing levels of debt (Italy), large current spending with little scope for "easy" cuts and efficiency gains (Greece), a rapid drop in GDP growth and consequent impact on fiscal revenues (Spain and Portugal), and large bank bailouts (Ireland). Given the pattern of public indebtedness, problems seemed to be concentrated in euro area countries that had fast but unsustainable growth in the pre-crisis years or that had pre-existing critical fiscal positions, or both (see Table 1).

4 The Build-Up of Imbalances

Problematic fiscal positions, under-performing economies and imbalances are long-standing weaknesses of the eurozone periphery, and they all predate the global financial crisis. Those countries that have been hit by the sovereign debt crisis—

[4] The size of the stimulus packages varied across Europe, from 3.8% of GDP in Spain to 0.2% of GDP in Sweden.

[5] Countries with a large export sectors, such as Germany and Japan, which up to then had been almost unscathed by the financial crisis, were severely hit by a sudden and sharp drop in their exports.

Greece, Ireland, Portugal, Spain and Italy—share a common problem of competitiveness, especially in terms of labor costs, which have been significantly rising since 1990 (Fig. 2). Consumer prices also grew faster in periphery countries than in Germany (Fig. 3). In Ireland and Spain, this reflected strong growth and overheating economies, in particular the housing sector, supported by low interest rates at the euro area level. In Greece, Portugal and Italy, high inflation was more a reflection of inefficiencies and distortions in labor and product markets.

The widening competitiveness gap between the euro periphery and Germany, and the emergence of large intra-EMU imbalances, are reflected in real exchange rates (Fig. 4). Since the early 2000s, Italy, Spain, Portugal, Greece and Ireland have been losing competitiveness vis-à-vis Germany.

These problems also show up in current account imbalances within the euro area. Although the euro area, taken as a whole, ran a modest current account surplus (0.3% of its total GDP in 2011), the figure masks large underlying imbalances across the region. With the exception of Ireland, all European economies facing severe fiscal problems are running current account deficits. This partly reflects the weaker export competitiveness of the euro periphery relative to the economies at the "core", which are mostly running current account surpluses (Fig. 5).

However, current account imbalances also signal problems in the capital market. Cross-border capital movements following the creation of the euro contributed to worsening capital account deficits of countries—such as Ireland, Spain and Portugal—that were the recipients of large capital inflows in the pre-crisis years. In contrast, Germany, which had experienced capital outflows, began to accumulate current account surpluses, rising from 2.8% of GDP in 2001–2005 to 6.3% in 2006–2010.

Even though the current account balances of the euro periphery have improved since 2008, for countries such as Greece and Portugal they are significant enough to suggest persistent imbalances that, far from being corrected by a slowdown in GDP growth, as in the United States, indicate structural problems in attracting capital flows. These countries are no longer able to finance their external imbalances through the capital market. As a result these countries, and their banks, have relied increasingly on financing from other euro area countries—in particular from the governments, central banks and official institutions. These structural imbalances have resulted in a build-up of inter-country imbalances in the settlement system. The large increase in Target 2 balances at the Bundesbank is yet another manifestation of the current account surpluses run by Germany.[6] More worryingly, the size and persistence of deficits in the periphery countries suggests longer-term structural problems in financing through capital markets.

[6] TARGET stands for Trans-European Automated Real-time Gross settlement Express Transfer system. TARGET 2 is the second generation of this system, which is owned and operated by the Eurosystem—the European Central Bank and the central banks of the member states that belong to the euro area—and which offers a cross-border payment service in the European Union. For further details, see the ECB website, Payments & Markets.

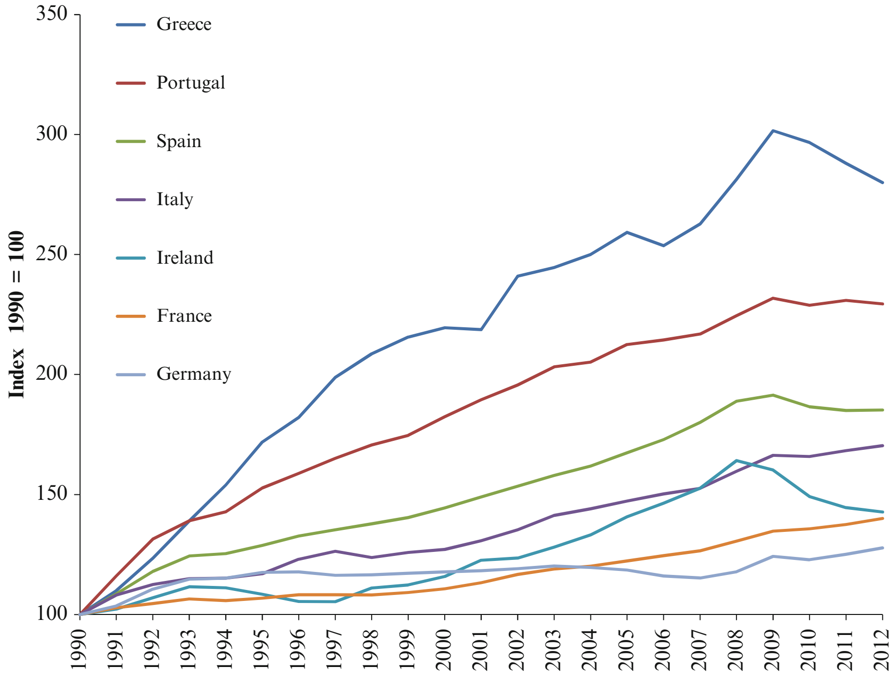

Fig. 2 Nominal unit labor costs (compensation per employee to real GDP per person employed) Source: AMECO

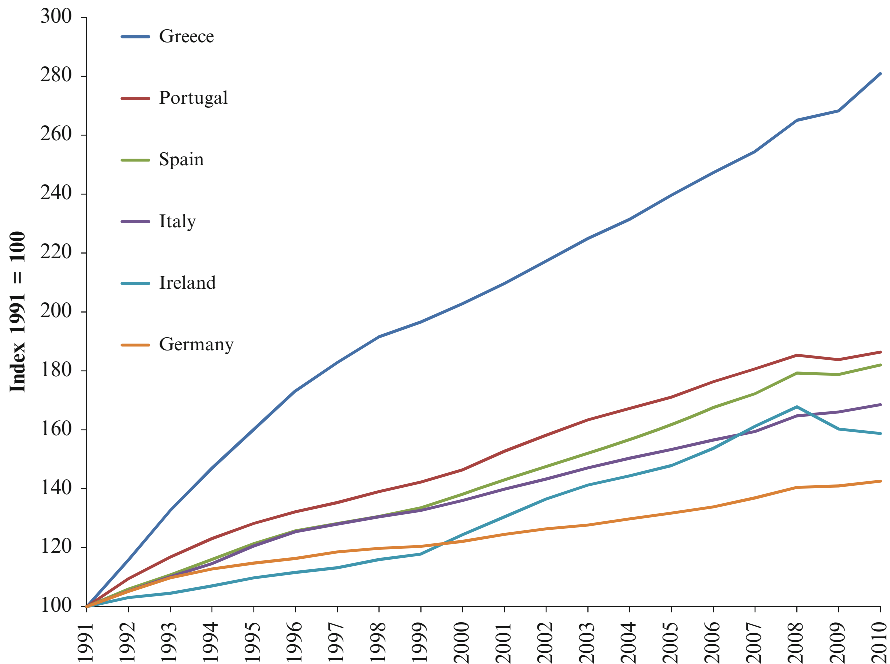

Fig. 3 Inflation in the euro area (Consumer Prices Index, 1991 = 100) Source: OECD

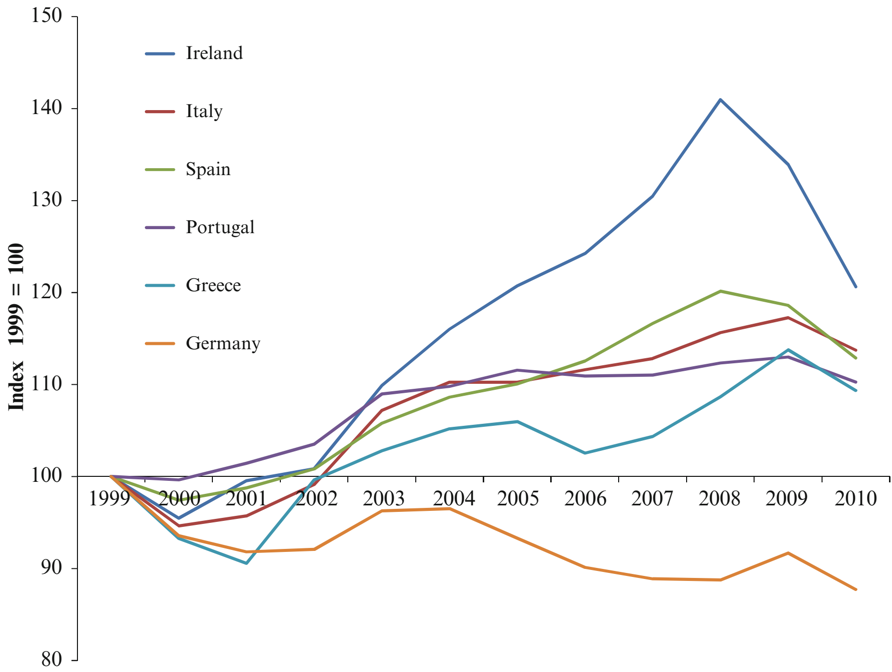

Fig. 4 Real effective exchange rates

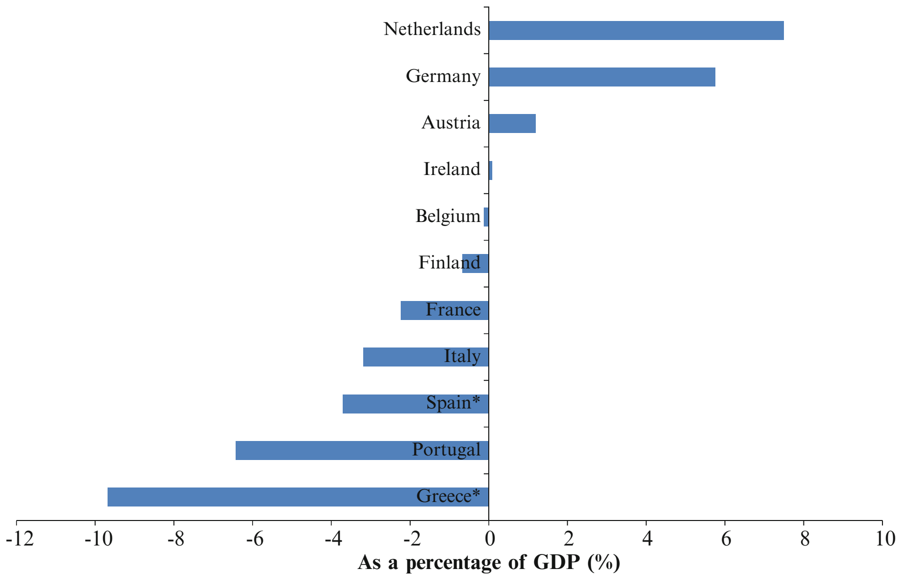

Fig. 5 Current account balances, Euro area, 2011. Source: IMF WEO

5 A "Two-Speed" Europe?

Significant differences have also emerged in the growth performance of different European countries. In large part, the phenomenon of a "two-speed" Europe exposes the difference between those countries that can live within the constraints imposed by the single currency and those that cannot.[7] A number of countries in the periphery (in particular, Greece, Portugal, Spain and Italy) are experiencing relatively low growth and high inflation, which is exacerbating their already problematic debt positions.

The growth problems of the periphery have also showed up in high unemployment rates. Again, Greece, Portugal, Spain and Italy have high and persistent unemployment, especially among youth, and with significant regional differences. Latest labor market figures show youth unemployment in Spain and Greece to be at 51.1% and 51.2%, respectively (Fig. 6). With German youth unemployment running at just below 8%, this again underscores the stark differences within the euro area and the practical consequences of a "two-speed" Europe.

The challenges for those countries in the euro periphery are a mix of urgent priorities and long-term measures. In the immediate future they have to convince markets that their public debts are getting back onto a sustainable track,

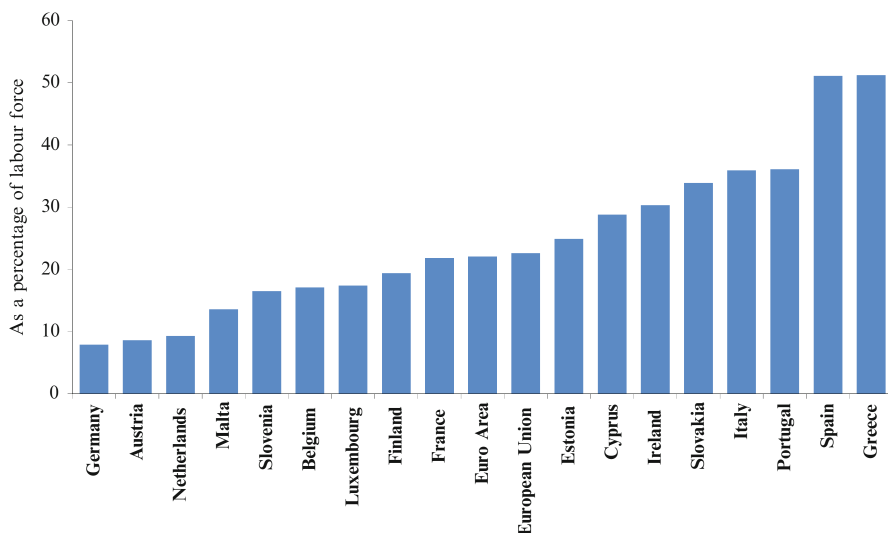

Fig. 6 Youth unemployment, Euro area, March 2012. Source: Eurostat

[7] This does not necessarily imply, however, that the latter should leave the EMU; however, they need to implement the necessary adjustments and resolve the mismatch.

which means not only credible fiscal consolidation plans but also stronger GDP growth. They also have to normalize the access of banks to market funding, reform their failing banks, and improve their external payments position. In the longer term the challenge is to achieve sustainable increases in growth and to improve competitiveness. However, none of these will be easy, in particular within the constraints of the single currency and its existing governance structure.

6 Lasting Solutions to the Euro Crisis

The euro crisis began in 2010. Since then numerous summits have been held and new institutions set up, a new treaty has been proposed to strengthen the oversight of national fiscal policies[8] and the eurozone countries have agreed to move towards a "European banking union".[9] However, throughout the crisis policy-makers have focused on dealing with the symptoms of the problem through a series of short-term fixes, taking decisions based primarily on political priorities and considerations. For instance, the strong resistance to the ECB acting as the lender of last resort or to issuing common bonds by the member countries primarily reflects domestic political priorities in Germany. In addition, the level of austerity imposed on the countries requiring financial assistance is partly to placate the electorates in creditor countries.

The result has been a deepening of the crisis, as the underlying structural problems have remained unaddressed. Not only have countries in the periphery found it increasingly difficult to finance their deficits at sustainable interest rates, but also markets have been questioning the survival of the euro in its current form (Buiter 2011). Solving the crisis of the euro requires not only dealing with the immediate problems facing Greece and other troubled countries in the periphery, but also addressing these structural problems.

[8] Leaders agreed at their December 2011 and March 2012 summits to enhance *ex ante* fiscal surveillance and budgetary processes in the euro area. More importantly, they agreed on an intergovernmental treaty of 25 governments (excluding the United Kingdom and Czech Republic) to support recommendations the Commission makes in the framework of the Excessive Deficit Procedure, leading to greater automaticity and a balanced budget rule at constitutional or equivalent level, and to recognize the jurisdiction of the Court of Justice on these issues. Furthermore, to ensure the financial stability of the euro area, the leaders agreed that the European Stability Mechanism (ESM) should enter into force in July 2012 instead of July 2013, and that urgent decisions in the ESM can be taken by qualified majority voting.

[9] At the Brussels summit in late June, European leaders decided to establish a banking supervisor as a way to contain the crisis, but also to address a shortfall in the design of the currency union. Centralised banking oversight is seen by Germany as the necessary condition for allowing the European Stability Mechanism to recapitalise banks directly.

There are three sets of long-term issues that need to be tackled:

- Helping countries in the periphery to live within the constraints of the single currency
- Adapting the governance of the euro to provide stronger sanctions but a fairer adjustment mechanism
- Adopting a growth model that allows the euro area as a whole and its constituent members to grow.

6.1 In the Short-Term: A Lender of Last Resort

It is still essential to implement short-term measures to stabilize the situation in a number of periphery countries to stabilize their fiscal positions and their banking systems. While the financial support for Greece, together with a write-down of privately held debt, helped to stabilize the Greek economy for a while, in the longer term it is far from clear that relying on fiscal austerity to improve Greece's competitiveness is politically sustainable.

Moreover, markets have still not been convinced that enough has been done to provide the resources that would constitute an effective firewall against contagion to other euro area countries. The European Financial Stability Facility (EFSF) and its successor institution, the European Stability Mechanism (ESM), will be stretched to cope with the support for Spanish banks agreed in June. The IMF too would need additional resources if it were to co-finance assistance packages for big euro area countries, but non-European countries are insisting that expansion of the EFSF/ESM is necessary if IMF resources are to be increased.[10]

The ECB also moved decisively to provide significant amounts of liquidity at longer maturities to ensure that European banks had sufficient liquidity to cope with the Greek debt crisis. However, the ECB has also made it clear that this is not its permanent role. Further, the Maastricht Treaty prohibition on monetary financing prevents the ECB from acting as a fully-fledged lender of last resort to countries in crisis. Changing that provision is almost certainly impossible, not only because of the political capital invested in it, but also because in a monetary union (and a banking union)

[10] The G20 finance ministers and central bank governors meeting held in late February 2012 insisted that the European nations had to build a more credible firewall before seeking help from the international community. Their Communiqué states: 'Euro area countries will reassess the strength of their support facilities in March. This will provide an essential input in our ongoing consideration to mobilize resources to the IMF' (G20, 2012). In March, the Eurozone increased its liquidity capacity. Then in June at the G20 summit in Los Cabos the G20 leaders agreed to increase the assets available to the IMF to more than $450 billion dollars, thus doubling the Fund's lending capacity.

it raises very difficult issues of burden sharing between the member countries. This means that it is even more important to press ahead with other longer-term measures to improve the functioning of the single currency.

6.2 Living Within the Euro

Membership of the single currency means that countries no longer have control over monetary policy, one of their main policy levers. That imposes additional constraints on fiscal and structural policies to maintain competitiveness, and macroeconomic balance (both internal and external). At present the single currency also places most of the responsibility for policy adjustment on countries with current account and fiscal deficits.

One of the biggest problems faced by periphery countries in recent years has been the persistent loss of competitiveness. In the absence of exchange-rate flexibility, countries have to rely more on fiscal policy and structural measures to achieve adjustments in relative prices and wages. At the European level, the Stability and Growth Pact (SGP) and the Lisbon process have provided frameworks to monitor and assist the necessary adjustments. In practice, though, neither has provided sufficient pressure to achieve policy adjustments at the national level. Strengthening the incentives for member countries to adjust their policies to maintain competitiveness is a priority.

The balance of responsibilities between deficit and surplus countries also needs to be re-thought. At present almost all responsibility lies on deficit countries to cut their fiscal deficits and to apply downward pressure on wages and prices. At the aggregate level this creates a bias towards deflationary policies. In theory, the ECB's monetary policy should adjust in response. However, there is currently little or no room for further reductions in interest rates. And this deflationary bias makes it harder for deficit countries to make the fiscal adjustments that are required.

With more effective fiscal control in countries with large deficits, European policy-makers would therefore face harder questions about the appropriate mix of macroeconomic policies at the aggregate level, including the possibility that countries with stronger fiscal positions should run more expansionary policies. The euro area, as a whole, is a large and relatively closed economy with substantial interconnections between its members. Running too tight an overall fiscal policy would have adverse effects on growth, at least in the short-term, especially in current conditions when growth is slow in other parts of the global economy.

6.3 Adapting to the Euro

Steps have been taken to improve the governance of the euro area in respect of fiscal policy. This is essential if the single currency is to be sustained and strengthened because it needs to move towards a fiscal union as well as a monetary union.

To increase the incentives for individual member countries to follow sustainable fiscal policies, the euro area must improve its surveillance of national economic policies, looking at all aspects of macroeconomic policy and performance. At present the concentration of the SGP on fiscal policy reduces its ability to identify wider macroeconomic imbalances.

Stronger sanctions are also required against member countries that do not follow sound fiscal policies. The SGP provided for fines on countries that breached fiscal guidelines. However, imposition of these fines remained to be decided by the member countries, and despite clear breaches of the guidelines in 2002 and 2003 the Council decided not to take this step.[11]

Finally, a framework for effective dialogue and decision-making for the overall fiscal stance at the euro area level must be developed. The ECB has strong analytical capacity to understand policy-making in the area of monetary policy. The euro area needs to build an equivalent capability for fiscal policy.

However, constructing what is in effect a federal structure for fiscal policy requires a clear understanding and agreement about the boundary between decisions at the euro area level and decisions that will remain purely national. It is also likely to highlight tensions over the fiscal adjustments required in different member states. This debate has already started as Greece struggles to reduce its fiscal deficit and debt. As part of the rebalancing of responsibilities for adjustment between surplus and deficit countries within the euro area, closer integration will make it impossible to ignore the politically difficult issue of fiscal transfers from the big surplus countries (in particular Germany) to the smaller countries running deficits, whether directly or through guarantees on deficit country debts. In the longer term, closer fiscal union is likely to require a permanent system of fiscal transfers.[12]

6.4 The Euro as a Zone for Economic Growth

While building a deeper currency union was intended to improve the growth prospects of all its members if they could adjust their domestic policy to the constraints of fixed exchange rates, there was a risk that it could also impart a bias against growth. Low growth makes it harder to run sound fiscal policies, and in extreme cases brings into play unsustainable debt dynamics.

The EU recognized many years ago the imperative of boosting growth. The Lisbon strategy was a response to this imperative.[13] However, if the aim

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[11] The SGP was breached by Germany itself (together with France) in 2003, but neither country was fined. The previous year Portugal was reprimanded, but not fined, for having had a deficit of more than 3% of GDP.

[12] The EU as a whole does allow limited fiscal transfers through structural and cohesion funds. However, these are primarily intended to encourage convergence between the poorer and richer regions, not to compensate for the loss of monetary sovereignty.

[13] The Lisbon strategy was adopted in March 2000 when the Heads of States met in Lisbon to set out a new strategy to make Europe more dynamic and competitive. Given the moderate results in the initial years, the strategy narrowed its focus to growth and jobs and was relaunched in spring 2005.

was to close the growth gap between Europe and other parts of the world, it must be seen as a failure.

Growth policies remain the objective of every government, but there is little consensus on what constitutes an appropriate growth strategy for the euro area as a whole. It is likely to require primarily country- or region-specific measures, although there is also a role for European-wide policies to boost growth.

The experience of the last decade suggests that a good start would be to avoid European policies that are likely to damage growth. A new framework for euro area governance would be a desirable first step: avoiding a deflationary bias to fiscal policy at the aggregate level, allowing monetary policy to provide appropriate support for growth, and rebalancing the adjustment burden between deficit and surplus countries to allow periphery countries to maintain competitiveness within a single currency. Another way to support growth would be further steps to complete the single market. The "European banking union" has the potential to help here, since there are still significant restrictions on cross-border provision of financial services.

Crises, especially financial crises, tend to have a huge negative impact on growth.[14] Setting in place a system that makes the euro area more stable and sustainable, and hence makes crises less likely, will itself make a big contribution to allowing Europe to enjoy faster growth over the longer term.

7 Conclusion: The Alternative

Without these changes, both to deal with the current crisis and to address some of the underlying problems that prevent the euro area from effectively coordinating its policies, it is hard to see the euro surviving in its current form. The costs and benefits of membership of the single currency are spread unevenly between its members, and the economic and political strains placed on individual countries by living within the constraints of the single currency are substantial.

Nevertheless, the benefits of membership of the euro are significant. Members are able to trade with each other without facing currency risk, and the economic costs of currency conversion are eliminated. Many of the periphery countries have enjoyed substantially lower borrowing costs, as well as significant political benefits from membership.

Ultimately, if the cost-benefit balance tilts too far, it could force the break-up of the euro, either by forcing out some of its weaker members or by encouraging the stronger members to leave because they are not prepared to accept the consequences for themselves. However, this would be a last resort option, and would potentially reverse the trend towards greater integration at all levels within Europe. Nevertheless, unless further changes are made to the structure of the single currency to put it on a sustainable footing, it may still come to pass.

[14] On how financial crises impact on the real economy see Rogoff and Reinhart (2009).

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