The Eurozone Crisis

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This report was created in response to the crisis faced by the Eurozone in 2010. The roots of the crisis lay in the global financial crisis that began in 2007 and it arguably reached its peak in 2010 when Greece faced sovereign debt problems. This report is designed to provide an exposition of the Eurozone crisis, examining the economic system of the Eurozone, and how it came under strain. It is aimed at more academically advanced pupils, but to ensure ease of reading, the report includes a series of ***'Explanation Boxes'*** (on the right-hand side) to give clear definitions of important terms, and further information about important points.

*NB. The intention of the report is to explain the Eurozone (the **European Union's Economic and Monetary Union, EMU**), not to give a verdict on its worth or future. However, the report does include an examination of the debates concerning the **Eurozone** and attempts to display both sides fairly in what is a complex issue.*

> ***EU Economic and Monetary Union (EMU):*** enshrined in the Maastricht Treaty (1992). Members of the EMU have diminished control over trade and monetary policy and give up some economic powers to supranational bodies. Full integration into the European Union EMU involves adopting the EU's single currency, the Euro.
>
> ***Eurozone:*** 16 EU member states who use the EU's single currency, the Euro.

1. History of the Eurozone crisis

From 2007, an international financial crisis caused a prolonged global economic downturn. Worldwide, few countries were left unscathed. Within the European Union, some states were particularly badly hit. For example, Greece faced a debt crisis which called into question the stability of the Eurozone's single currency, the ***Euro***, and the future of the EU's Economic and Monetary Union (EMU). It remains to be seen whether the Eurozone can successfully negotiate its way through the economic storm.

> ***The Euro:*** the currency used in the 16 EU member states who have signed up to full EMU. Euro notes and coins were first launched in 2002. The single currency (the Euro) was intended to be a symbol of a European identity, and to enable:
> - a financial complement to the single market;
> - more trade (removing currency exchange costs);
> - a stronger EU presence in the global economy.

What is the Eurozone?

'The Eurozone' is the nickname commonly used to describe the member states that use the EU's single currency, the Euro. The idea of creating a single currency for the European Community was first mentioned in the 1970 Werner report, which led to the establishing of the ***European Monetary System (EMS)***, the forerunner of the Economic and Monetary Union (EMU). The Maastricht Treaty (1992) made EMU a part of EU law and set out a plan to introduce the single currency (the Euro) by 1999. The Maastricht Treaty also established certain budgetary and monetary rules for countries wishing to join the EMU (known as the ***convergence criteria***).

In 1998, 11 member states (Germany, France, Italy, Belgium, Luxembourg, the Netherlands, Spain, Portugal, Ireland, Austria and Finland) undertook the final stage of EMU when they adopted a single exchange rate, which was set by the ***European Central Bank*** (Britain, Sweden and Denmark negotiated an opt-out from this final states of EMU). The new Euro notes and coins were launched on 1 January 2002.

> ***The European Monetary System (EMS):*** a way of creating an area of currency stability throughout the European Community by encouraging countries to co-ordinate their monetary policies. It used an Exchange Rate Mechanism (ERM) to create stable exchange rates in order to improve trade between EU member states and thus help the development of the single market.
>
> ***Convergence criteria:*** countries need to fulfil 4 criteria before they can join the Euro, including: keep the budget deficit below 3% of GDP; keep public debt below 60% of GDP; demonstrate long-term price stability; and ensure interest rates remain within certain limits for at least 2 years.
>
> ***European Central Bank (ECB):*** central bank of the Eurozone. It controls the monetary policy of all the member states that use the Euro.

There are currently 16 EU states in the Eurozone. Greece joined the initial 11 members in 2001, Slovenia joined in 2007, Cyprus and Malta in 2008, and Slovakia joined in 2009. Estonia is due to join the Eurozone in 2011. All future members of the EU must adopt the Euro when they fulfil the convergence criteria.

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The global economic downturn – effects on EU states

A number of Eurozone states were particularly badly hit by the economic downturn. In April 2010, Eurozone unemployment reached an all-time high of 15.86 million (10.1% of the Eurozone population).[i]

In 2009 alone, 14 Eurozone states breached EU rules limiting ***public debt*** and annual ***budget deficits*** as defined by the ***Stability and Growth Pact (SGP)***.[ii] In the same year, Spain's unemployment rate reached 19%,[iii] and its annual budget deficit grew to more than 11% of ***Gross Domestic Product*** (***GDP***).[iv] Italy's public debt reached €1.812 trillion in April 2010, its highest ever level.[v]

In response to the global economic crash, member states across the EU proposed tough ***austerity measures*** to try to reduce their budget deficits and public debt. The Spanish Government proposed to cut public sector pay by 5%.[vi] Italy's Prime Minister, Silvio Berlusconi, introduced measures to reduce Italy's budget deficit to 2.7% by 2012.[vii] In June 2010, Germany's Government also promised to reduce its ***public spending*** by €80 billion over the next 4 years.[viii] The measures to cut public spending led to protests and strikes across the EU, including in Spain, Italy and France.

Public debt: money owed by government (often expressed as a percentage of GDP).

Budget deficit: when a country spends more than it receives. This is calculated annually and often expressed as a percentage of GDP.

The Stability and Growth Pact (SGP): outlines rules on public finances, including:
- limiting public debt to 60% of a state's GDP.
- limiting the annual budget deficit to -3% of GDP.

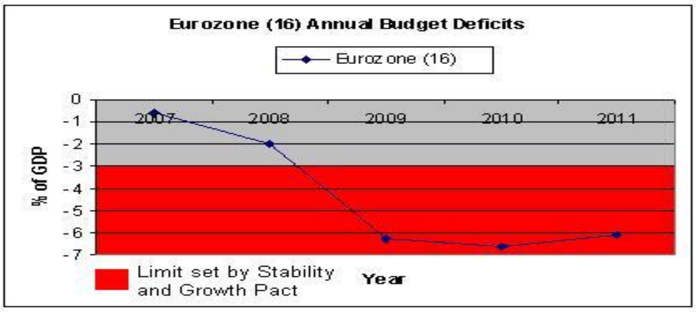
The rules are intended to encourage good economic management:
- stable prices, low inflation and low interest rates;
- more resilience to external economic 'shocks'.

The Euro doesn't create economic stability on its own, but stability was meant to be achieved by states sticking to the SGP rules.

Gross domestic product (GDP): measure of the value of all goods and services produced in a country in a year.

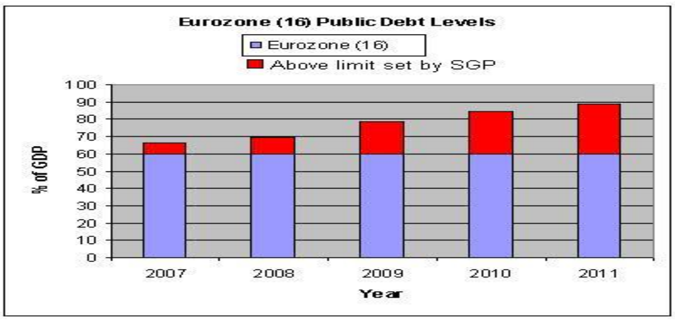
Austerity measures: tough reductions in government spending, often coupled with higher taxes to try to reduce the budget deficit and public debt.

Public spending: spending by a government.



This graph shows the deterioration of the Eurozone's finances since the beginning of the financial crisis. The average budget deficit in the Eurozone fell from just above –1% in 2007 to a predicted peak of –6.5% in 2010. The area in red shows the limit for budget deficits set by the Stability and Growth Pact (-3%).[ix]

This graph shows how the average public debt level in the Eurozone has increased dramatically since the beginning of the financial crisis. In 2007, public debt in the Eurozone was just over 65% of GDP, whereas by 2010 debt levels were predicted to rise to 85% of GDP (and to nearly 90% by 2011). The part of the graph in red shows the projected excess over the limit for debt levels set by the Stability and Growth Pact (60%).[x]



The Greek debt crisis

The EU member state most severely hit by the global economic crisis was Greece. When the Eurozone was established, Greece was initially refused membership of the single currency area, due to its weak economy and failure to meet the required economic criteria. The Greek Government was told to implement a series of austerity measures to improve its economy.

In 2001, the EU revised its opinion and Greece became the 12th country to join the Eurozone. However, concern about the strength of Greece's economy remained as many argued that the country had not adequately reformed its economy or reduced its public spending, including the huge military budget. There was also suspicion (which was later confirmed) that Greece had doctored its economic data to cover up its poor financial situation.[xi]

When the global economic crisis hit, Greece's dire finances became apparent; in November 2009, the country's public debt was predicted to rise to 124.9% of GDP (€300 billion) during 2010, the highest level in the EU.[xii] The Greek Government also announced that its 2009 budget deficit would be equivalent to 12.7% of its GDP, more than four times higher than the maximum allowed under the EU's Stability and Growth Pact.[xiii]

One problem Greece faced was that it needed to borrow €50 billion in 2010 just to ***service its debt,***[xiv] but banks and investors were worried that it might not be able to pay the money back. As a result, Greece's ***credit rating*** was downgraded, so it had to pay much higher interest on its borrowings than other Eurozone states.

> ***Servicing debt:*** the amount needed by a debtor to pay the principal (money borrowed) and the interest, over time.
>
> ***Credit rating:*** a grade (between AAA–D) given to a country by a ratings agency (such as *Standard & Poor's*). Outside investors use the rating to ascertain the ability of a debtor to back a loan.
>
> ***Bailout:*** money given to help a company or country out of financial difficulties.

At first, the Greek Prime Minister, George Papandreou, insisted that Greece would not need a ***bailout*** from Eurozone states and, in November 2009, Papandreou promised to cut Greece's budget deficit to 8.7% of GDP during 2010.[xv] To achieve this, he announced tough austerity measures for 2010, including a 10% reduction in social security spending, and a freeze of public sector wages. He also promised to reform the pension and tax systems to make sure wealthier people paid more, and to fight corruption and tax evasion. However, despite Greece's proposed public spending cuts, in March 2010, EU Economic Affairs Commissioner Olli Rehn asked the Greek Government to take further measures to tackle its budget crisis. The country's credit rating was repeatedly downgraded, eventually reaching 'junk-status' (below 'BBB', according to ratings agency *Standard & Poor's*) in April 2010.[xvi]

In response, Greece said it wanted to cut its budget deficit to 2.8% of GDP by 2012[xvii] and the Greek Government promised to save an extra €4.8 billion by cutting public sector pay (cutting salary bonuses by 30% and freezing state-funded pensions in 2010) and increasing taxes (on fuel, tobacco, alcohol, and raising VAT from 21% to 23%).[xviii]

There were widespread protests against the austerity measures in Greece. On 24 February and 11 March 2010, 50,000 people - including Greek transport workers and civil servants – took part in general strikes. The situation deteriorated further in May 2010, when three people were killed in violent protests.

What could the EU do to help Greece? EU member states discussed several possible solutions. The first possible solution was to let Greece ***default*** on its debt. However, this was opposed by member states whose banks held Greek debt (including the UK) because they would lose money.

> ***Default:*** when a debtor cannot pay back a debt, including the interest accumulated on the principal (money borrowed).

Moreover, members of the Eurozone were worried that allowing Greece to default would undermine investor confidence in the Euro. A second possible solution, proposed by France, was to arrange a bailout for Greece from the European Central Bank (ECB), the EU, or the ***International Monetary Fund (IMF)***. However, some states, including Germany, were concerned that a bailout (particularly involving external international institutions such as the IMF) would further undermine the credibility of the Euro and signal the failure of the great 'economic monetary union experiment'. A third possible solution was for Greece to leave the Eurozone and return to its old currency, the Drachma.

> ***International Monetary Fund (IMF):*** an organisation of 187 countries. It provides policy advice and financing to members in economic difficulties.

Why didn't Greece leave the Euro?

The EU does not have a comprehensive mechanism for states that want (or need) to leave the Eurozone: no member has ever tried to leave the Eurozone, and there are no specific 'rules' or 'procedures' for how to do it. [xix] This meant there was no clear route for Greece to leave the Eurozone if it wished, or to be expelled by the other Eurozone members. When the Eurozone was designed, a 'get-out' clause was not established because:

- the EU's political aim of working towards an 'ever closer union' (set out in the 1957 Treaty of Rome) was designed to be irreversible;
- a 'get-out' clause might have encouraged irresponsible economic behaviour from Eurozone states;
- given that some states already had 'opt-outs' on aspects of EU integration, the EU would look increasingly like a 'pick and mix', with individual states having a different relationship with the EU.

NB. An ***'Exit Clause'***[xx] inserted into the Lisbon Treaty (2007) allows member states to leave the EU altogether.[1] However, there is no mechanism for states to only leave the Eurozone whilst remaining a member of the EU.

> ***The 'Exit Clause':*** Article 50 of the Lisbon Treaty establishes the only provision for member states to weaken their ties with the EU, by allowing members to leave the EU altogether.

The €110 billion Greek bailout

Despite initial reluctance, in April 2010, the 16 Eurozone countries agreed to lend Greece €30 billion worth of low interest loans during 2010 – they insisted it was 'not a direct bailout' but a 'funding mechanism' to be used as a 'safety net' if Greece's problems worsened.

However, it quickly became apparent that Greece would need further funds and stronger financial backing from the EU. Therefore, on 2 May 2010, Eurozone states and the IMF agreed a bailout package for Greece in the form of a 'Stabilisation Mechanism' - a fund that low interest loans could be drawn from. The fund was worth a total €110 billion, with Eurozone countries providing €80 billion and the rest (€30 billion) coming from the IMF. In a move to restore confidence in the Euro, the fund was made available to all Eurozone members. Greece withdrew the first loan on 18 May 2010.

The Stabilisation Mechanism loans had a much lower interest rate than private bank loans, but came with tough conditions in order to protect member states that had given huge quantities of money to the fund. For Greece, these conditions included: allowing auditors from the IMF and the EU to assess its national budget and judge the success of its austerity measures; and imposing important structural changes to its economy on an annual basis for the duration of the loan.

The decision to 'bailout' Greece was controversial because a number of EU treaties forbid the explicit 'bailing out' of member states (the Maastricht Treaty specifically prohibited bailouts, and the Lisbon Treaty created a ***'no-bailout' clause***. Bailouts had originally been banned in order to prevent states from breaking the SGP rules, and then being propped up by other member states. However, to allow the Greek bailout, the 'no-bailout' clause was overruled and the Lisbon Treaty's ***'exceptional occurrences' clause*** was used instead.

> **The 'no-bailout' clause:** 'The Union shall not be liable for or assume the commitments of central governments.' (Lisbon Treaty, Article 125)
>
> **The 'exceptional occurrences' clause:** 'Where a member state is in difficulties or is seriously threatened with difficulties caused by natural disasters *or exceptional occurrences beyond its control***,** the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the member state.' (Lisbon Treaty, Article 122)

The Greek 'bailout' had repercussions for many EU states. For example, Germany contributed €22.4 billion to the fund (the greatest amount from any EU member state). As a consequence, Germany's Chancellor, Angela Merkel, faced anger from German voters and her party (the Christian Democratic Union, CDU) lost a key regional election in May 2010. Furthermore, in August 2010, Slovakia (a Eurozone member) voted against contributing to the Stabilisation Mechanism in its national parliament, insisting it was 'too poor to help Greece'. Germany publicly criticised Slovakia's decision.[xxi]

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[1] It is not clear how this would actually work in practice as it has never been used before.

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Originally, EU states that are not members of the Eurozone (including the UK) were not going to contribute to the Stabilisation Mechanism; however, the use of the 'exceptional occurrences' clause meant that the UK was required to ***underwrite*** £13 billion of the fund.[xxii]

To underwrite a loan: accepting financial liability if loans can not be repaid.

The Greek debt crisis caused concern that further Eurozone states with 'weak' economies would default. For example, Spain, Portugal, Italy and Ireland all had big budget deficits. Ultimately, fear that the Greek economic crisis would 'infect' other states undermined the credibility of the EU's single currency worldwide. In May 2010, the Euro fell in value against the dollar to its lowest level for 4 years. Many began to question whether, in such a time of economic turmoil, the economically stronger northern European states, such as Germany, Finland and France, would act to support the economically weaker states, in order to save the European Union's EMU.

The €690 billion European Financial Stability Facility (EFSF)

As concern about the stability of the Euro grew, the 16 Eurozone states agreed to set up a Eurozone-wide fund to remove the fear that weak Eurozone states wouldn't be able to repay their debt. The resulting fund, the European Financial Stability Facility (EFSF) was established in May 2010. Eurozone states provided €440 billion, in conjunction with the IMF, which provided an additional €250 billion.

The EFSF established a safety net for the 16 Eurozone states (but not the full 27 member states of the EU) particularly those in dire financial straits, by giving them access to a total of €750 billion emergency funding (this includes the Eurozone and IMF contributions along with €60 billion from the 'Stabilisation Mechanism' described above).

To raise the funds, the EFSF is able sell bonds to investors guaranteed by Euro area members. The amount raised in bonds sales can then be lent to Eurozone member states. If a country does draw funds from the EFSF, the IMF will begin an investigation and the country will no longer have an obligation to contribute to the facility (i.e. Greece has not contributed). The EFSF has the status of a registered company owned by members of the Eurozone and is based in Luxembourg.[xxiii]

The EU's economic response after setting up the EFSF

After the Greek 'bailout' and the creation of the EFSF, the EU looked to implement wider reforms to reach a long-term solution. To date, a number of responses have been outlined by member states, the European Council, European Commission and a new Economic Task Force[xxiv] (established after the crisis and led by the President of the European Council, Herman Van Rompuy). These responses include:

Europe 2020 strategy to create jobs and sustainable growth.[xxv] The strategy's targets include:

- 20 million fewer EU citizens should be at risk of poverty;
- 75% of the population aged 20-64 to be employed;
- the share of early school leavers should be under 10%;
- 40% of the younger generation to have a degree or diploma;
- the EU's ***20-20-20 climate targets*** should be met;
- 3% of EU GDP to be invested in research and development (R&D);

'Economic governance' (suggested by France and Germany):

- more surveillance of member states' national budget plans to make sure they are better coordinated with the SGP;
- create a mechanism to examine states' competitiveness;
- use the new ***European Systemic Risk Board (ESRB)***;
- expand ***Eurostat*** giving it greater powers to ensure that statistics produced by member states are correct;[xxvi]

20-20-20 climate targets: part of the 2008 EU Climate Change package. The targets (to be achieved by 2020) include:

- 20% of energy to come from renewable sources;
- reduce greenhouse gas emissions to 20%.

'Economic governance': this term repeatedly features in debate on the future of the Eurozone. However, it has a number of interpretations:

- ***France:*** sees economic governance as harmonised taxes and labour laws and redistribution of funds between regions. France wants such governance to cover only Eurozone countries.
- ***Germany:*** sees economic governance as harmonised budget discipline, competiveness and a commitment to German 'thriftiness'. Germany wants such governance to cover all EU member states.
- ***European Central Bank (ECB):*** describes economic governance as the oversight of EU states' fiscal sustainability by all other EU members, along with the creation of an independent fiscal agency and sanctions for members who break the rules.

European Systemic Risk Board: will monitor risk across the whole European financial system from 2011. The ESRB will advise bodies deemed risky and - if advice is not followed - inform the EU Council of Ministers.

Eurostat: the statistical office of the EU. It harmonises statistical methods and provides statistical information across the EU.

- enforce compliance with EU budgetary rules through economic sanctions (e.g. fines) and political sanctions (e.g. the suspension of voting rights);
- set up of a 'credible crisis resolution framework' to respond to any future crises;[xxvii]
- overhaul European financial regulation, using the 3 new European supervisory agencies under the ***European System of Financial Supervisors (ESFS)*** to begin work in 2011.

> ***European System of Financial Supervisors:*** will work with national bodies to supervise individual financial institutions. The 3 new European authorities are:
> - European Banking Authority (EBA)
> - European Insurance and Occupational Pensions Authority (EIOPA)
> - European Securities and Markets Authority (ESMA)

'***Stress-tests***' ***of European banks:*** To reassure investors about the strength of European Banks, the EU carried out a month-long examination of Europe's biggest banks. The 'stress-tests' were carried out by the national banking regulator in each European country (i.e. in the UK, this was the Financial Services Authority, FSA). The results, released in July 2010, showed that out of the 91 banks that were tested (representing 65% of the European banking sector), only 7 failed; these banks (5 from Spain, 1 from Germany and 1 from Greece) would need a total of €3.5 billion to meet the required standards. There was widespread criticism of discrepancies between the national tests; some countries carried out more stringent tests (predicting greater loses and requiring banks to have higher levels of capital to be able to survive future problems). It was widely concluded that the tests held in America in 2009 were more rigorous. Reactions to the stress-test results from financial markets were mixed and many were sceptical about whether the results would reassure investors enough to restore funding to Eurozone banks (compared to the United States, European banks have far more debt – European debt isn't projected to drop below $0.5 trillion (€380 billion) until 2013). [xxviii]

> ***Bank stress-tests:*** examining a bank's debts and assets to predict how they would cope in a volatile, negative financial situation.

Basel III Agreement:[xxix] In September 2010, the ***Bank for International Settlement (BIS)*** agreed new, stricter rules for banks, with the aim of avoiding another major global financial crisis. The new rules (known as the *Basel III Agreement*) aim to prevent banks from incurring major losses in financially hard times. The most important rule requires banks worldwide to increase their ***capital ratio*** (from 2% to 7%). In difficult times, banks will be allowed to reduce their capital ratio to 4.5%; however, they must restrict the bonuses and dividends they pay out until they return to the regular 7% capital ratio. The Basel III rules set out minimum standards that all banks must comply with, but national governments can decide whether to set higher standards. The rules must be fully implemented by 2019.

> ***Bank for International Settlement (BIS):*** an international organisation that promotes financial and monetary cooperation and acts as bank of central banks. It was established in 1930 and brings together heads of central banks and senior bank regulators from 27 countries. The bank is based in Basel, Switzerland.

> ***Capital ratio:*** proportion of capital to assets held by a bank. Banks with a higher capital to assets ratio are generally considered to be more financially sound.

2. Theory behind the Eurozone

What is an Economic and Monetary Union and how does it work?

Before analysing the Eurozone and assessing its benefits or costs for the countries involved, it is important to understand what changes for a country when it joins an Economic and Monetary Union (EMU), such as the Eurozone. The process (outlined below) sees states move from having full control over their monetary and economic policy, to giving over full control of their monetary policy (and partial control of economic policy) to ***supranational*** bodies.

> ***Supranational:*** form of organisation through which decisions are made by international institutions, not by individual states.

NB. The Eurozone is not the world's only EMU, others include the West African Economic and Monetary Union (UEMOA) and the Eastern Caribbean Currency Union. (For ease of reference, the EU's EMU will be referred to hereafter as the 'Eurozone'.)

The process of joining an EMU:

Stage 1 – *Full monetary and economic sovereignty*: in a state with full control over its monetary policy, the country's ***central bank*** - whether independent or controlled by the Government - has the power to set interest rates, can devalue the currency and print money. Supplementing this, the bank and/or Government has a degree of power over the wider economy.

Step 1: a country loses a degree of economic sovereignty when it enters a trade bloc or single market as a necessary step towards being part of an EMU.

Stage 2 – *Joining a trade bloc or single market*: to join a single market, or a trade bloc, a country must give up a degree of power over trade. Such powers can include: import and export tariffs, product regulations and free movement of goods and people.

Step 2: to move from being part of a single market to being part of a full EMU, monetary powers must be transferred from the national to the supranational level, so that a uniform monetary policy can be set for all countries.

Stage 3 – *Incorporation into an EMU*: being part of an EMU means adopting a common currency and giving up monetary powers. For instance, countries in the Eurozone cannot set their own interest rates (if the Euro had many different interest rates it would cease to be a single currency). Along with having diminished control over trade and monetary policy, being part of an EMU also involves members giving up other economic powers to supranational bodies. The EU currently has a degree of power over the economic policies of its members and there is debate about whether this should be increased, or indeed, decreased.

NB. The UK is part of the EU single market but opted-out of the Eurozone. However, new member states must join both the single market and, once they fulfil the convergence criteria, the Eurozone.

Trade bloc: composed of countries that decide to reduce or eliminate trade barriers between themselves.	***Central bank***: puts official financial plans into operation. It sets a common interest rate for the country, controls the amount of money in the economy, and has the sole right to lend a government its money.

The benefits and costs of being part of an EMU

Integration within an EMU sees a country lose important powers, so why would a country do this? What are the benefits of being part of an EMU and do they outweigh the costs?

NB. The costs and benefits listed below do not take into account the cost of the current economic crisis, which is examined separately in the section: 'Eurozone Crisis, was it inevitable?' (p.10)

Benefits:

1) Uniform interest rates

Theory: Currency flows around an EMU will not be affected by differing ***interest rates*** in different states. Investment is attracted by low interest rates, and discouraged by high interest rates; this would equalise within an EMU and promote investment throughout the currency union.

Evidence: It has been argued that, since 1998, 22% of investment in Eurozone countries with previously weak currencies was due to their membership of the single currency.[xxx] The market share of companies from countries who previously had weak currencies, has increased since the introduction of the EMU. However, financially unconstrained companies from Eurozone countries with previously strong currencies have seen a fall in investment.[xxxi]

Interest rates: the fee that lenders charge to those borrowing money. Borrowers must pay back the loan plus the interest. For countries outside an EMU, their central bank sets an interest rate which affects how much banks charge their customers. Within an EMU, states can't set their own interest rate. As a result, countries in an EMU that experience a slow down in economic growth cannot lower interest rates to encourage borrowing.

2) Transaction costs reduced and exchange rate fluctuations ended.

Theory: Within an EMU, it doesn't cost money to exchange currencies. This should save people money and help businesses to grow. Ending ***exchange rate fluctuation*** should promote inter-country trade; previously, when trading with companies in other countries, businesses would have been at risk of changes in exchange rates (which could have reduced the ***purchasing power*** of their currency or raised the price of their products).

Evidence: When the EU was debating whether to set up an EMU, supporters of an EMU argued that its members would save a total of $30 billion (€23 billion) from reduced ***transaction cost;*** however, it is not clear if this has really happened. Studies suggest that, since the introduction of the Eurozone, reduced costs associated with exchange rate fluctuations are 'statistically and economically small'.[xxxii] In terms of the effect on overall levels of trade, the benefits of the EMU are debateable. Some studies put the growth in trade at between 3-10%.[xxxiii]

Exchange rate fluctuation: when currencies change in value relative to one another, e.g. the value of the Pound Sterling (£) fluctuates in relation to the value of the Dollar ($).

Purchasing power: the amount of goods and services that can be bought with one unit of currency, e.g. £1 today buys less than £1 a decade ago, thus the Pound's 'purchasing power' has decreased.

Transaction costs: the costs incurred through the trade (not the cost of the item), when something is bought or sold.

3) Financial integration.

Theory: The creation of an EMU reduces the cost of financial firms integrating across national boundaries in the EMU area.

Evidence: Since the creation of the Eurozone there is evidence of lower transaction costs for financial firms inside the EMU and reduced transaction costs for those firms trading in ***EU bonds or stocks***.[xxxiv]

EU bonds and stocks: bonds are a form of asset bought by investors from governments. Stocks, when bought, signify a degree of ownership of a company.

Currency speculation: when investors bet that a currency's value will fall (relative to other currencies). They make money by ***short-selling*** the currency they expect to fall in value.

Short selling: when investors borrow shares they don't own, and sell them in the hope their price will go down. If it does, they buy back the shares at the lower price, return them to their owner and pocket the difference.

4) The end of speculation and competitive devaluations.

Theory: ***Currency speculation*** would end with the creation of a single currency. Speculation can be damaging if the actions of some speculators 'spook' others and cause lots of people who have invested in the currency to move their investments somewhere else.

Competitive devaluations can also be damaging if other countries devalue their currencies in response, creating a wave of devaluations. Both speculation and competitive devaluations can result in increased ***inflation*** as currencies become worth less, and so the price of goods and assets will rise.

Evidence: The Eurozone prevents competitive devaluations and speculation because all its members have a single currency with a single value. Since the introduction of the Euro, average inflation within the Eurozone has been around 2%.

Competitive devaluations: when countries compete to reduce the rate at which their currency can be exchanged for foreign money (its 'value').

Inflation: a rise in the general level of prices of goods and services in an economy. Such a rise reduces the purchasing power of money.

5) Economic cushioning from domestic political instability.

Theory: Countries with weak or unstable political systems often see their economies suffer as a result of domestic political problems. The establishment of an EMU would integrate politically weak countries into the wider economic union, thus shielding their domestic economies from domestic 'political shocks'.

Evidence: Studies by the ECB have noted that the monetary benefits of the EMU (a lower interest rate contributing to lower inflation, etc) have reduced the effect that domestic political problems in weak Eurozone countries have on market expectations, and thus on domestic and international markets.[xxxv]

NB. There are, however, a number of caveats to this point. First, whilst this is an advantage for politically 'weak' countries, the implications for politically 'strong' countries are mixed. Stronger countries are also partially shielded from economic effects of domestic political developments, but they lose the stabilising influence of their strong political systems. Secondly, all economies are exposed to Eurozone-wide political instability which, in certain circumstances, may have worse economic effects than domestic political instability. Thirdly, the fact that politically weaker or unstable countries no longer feel the full economic effects of their political failings may create a disincentive to reform their political systems.

Costs:

1) Loss of devaluation power.

Theory: If a country loses the power to devalue its currency, it reduces that country's ability to respond to economic problems. For instance, in the event of a recession, a country would not be able to devalue its currency to boost its exports (by making the goods it produces cheaper, relative to other countries), thus hopefully improving its economic growth.

Evidence: Argentina conducted a reasonably successful devaluation in 2002 (however, the success of this devaluation is still being debated), yet it is important to remember that devaluation alone is not always enough to improve a country's economy.

(NB. There is further discussion of the merits and possible costs of devaluation below in the 'Arguments for reforming the Eurozone' section below on p.15.)

2) Loss of power to set interest rates and control the supply of money.

Theory: Having the ability to set interest rates and control the ***money supply*** can allow governments to influence levels of inflation and employment.

Inflation can be reduced by setting interest rates high and limiting the supply of money (or it can be increased by doing the opposite). Some economists see the ability to influence inflation as a key governmental power. For instance, if a country wanted to reduce the burden of its debt (by making it worth less) it could increase inflation - this may be better than defaulting on the debt (although the effectiveness of such a mechanism is debated by economists). On the other hand, governments may want to reduce inflation to promote investment (a country's assets will be more appealing if its currency is seen as stable, i.e. if inflation is low).

Money supply: the amount of money in an economy. A central bank can increase the amount of money in the economy by buying government bonds. (Methods to increase the supply of money into the economy are technically known as 'quantitative easing'.) A central bank can sell bonds back to the Government if it wants to reduce the money supply.

The ability to control interest rates can also influence the level of employment in an economy because setting low interest rates can encourage businesses to borrow money (knowing that the interest on their loans will not be too

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high), which can enable businesses to employ more people, thus lowering unemployment. The opposite is also important - a central bank could raise interest rates to encourage saving and reduce borrowing, perhaps at a time when an economy was threatened by increasing debt defaults (as the world economy was following the recent problems in the US housing market).

Evidence: Following the onset of the economic crisis, the Bank of England set very low interest rates to encourage lending. The hope was that banks would want to borrow from one another (as the interest on the loans would be low) and would therefore have more money to lend to businesses, thereby stimulating the economy at a time of recession. However, one criticism of this move is that it simply increases the issuance of 'bad loans', which was one of the main causes of the current crisis.

How do currencies get their value?
Some critics of the Eurozone question whether a single currency can be suitable for many different economies. A currency's worth is linked to the strength of its economy; however, there is no simple link between the two.

In the past there was a concrete link between currency and value - when a ***gold standard*** existed. This system made it easy to ascertain the strength of a currency relative to other currencies. However, US President Nixon severed this link in 1971 when he ended the direct convertibility of the dollar to gold. By finally severing this link, the currency market was subject to fluctuation and speculation about the price of currencies. This was because there was no longer one currency that had a definite value (governments could artificially devalue their currencies). As a result, currencies ***floated*** or were ***pegged*** to the value of other currencies.

This doesn't necessarily mean we cannot evaluate currencies or the suitability of currencies to be unified in an EMU, but it does mean that evaluation must be based on more than just the intrinsic value of these currencies (as from 1971, currencies could only be attributed a 'relative', not an 'absolute' value).

The gold standard: when currencies were all tied to a commodity (gold), which people valued equally. This allowed direct comparisons between currencies that were less open to debate. For example, if one US dollar ($) was valued at 100th of an ounce of gold and one British Pound (£) was worth $10, then one could calculate the worth, in gold, of £1 (10th of an ounce of gold, in this case). Fewer British £s than US $s would be needed to purchase greater amounts of US goods, because the British £ was the stronger currency.

Floating and pegged currencies: a floating currency is one with a value that is *not* fixed directly to another currency, it thus 'floats' and has a value relative to other floating currencies. A 'pegged' currency's value *is* fixed to that of another currency. For instance the Chinese Yen is 'pegged' to the value of the US $ (thus its value is always a proportion of the dollar's value).

The Eurozone crisis, was it inevitable?

To answer whether the recent crisis in the Eurozone was inevitable, we must look at whether the Eurozone is suitable for the countries that are part of it. The previous section outlined some of the benefits and costs of EMUs in general. This section uses suitable criteria to evaluate the EU EMU (the Eurozone) in particular.

Evaluating the viability of the Eurozone:

Analysis of the viability of economic and monetary unions is linked to the concept of an '***optimum currency area'*** pioneered by the economist Robert Mundell in 1961.[xxxvi] We can use Mundell's criteria to evaluate the suitability of the Eurozone countries to form an EMU:

Optimum Currency Area (OCA): Mundell argued that an area formed an OCA when the benefits of adopting a single currency would be greater than the costs of each country losing monetary and economic independence. To evaluate whether an area was suitable, he proposed criteria to evaluate the degree of integration between the different economies. Subsequent academics (e.g. Ronald McKinnon) added to Mundell's criteria.

1) **Labour mobility.** Enabling workers to freely move around and between the different economies is necessary to efficiently distribute workers where they are needed.

   The Eurozone does not score highly on this point; language is a significant barrier to labour mobility, as is the limited transferability of qualifications between different states.

2) **Openness with capital**. Free movement of ***capital*** is important as it allows companies and people to invest across national borders, and it allows banks to conduct business across the EMU.

   Fewer than 5% of commercial bank loans are issued across EU states' borders. However, this is likely to increase because the EU made restrictions on capital movements illegal in the early 1990's and has since been ensuring that restrictions are removed (although there are some exceptions).

Capital: money and possessions used to produce more wealth, or for starting a new business.

3) **Wage and price flexibility**. This allows the differences between the supply and demand for labour to be affected, perhaps through reducing wages or working hours.

The Eurozone does not score highly on this point. Wage flexibility is affected by unionisation (workers who are members of unions), and by national labour laws and controls.

4) **Fiscal transfer mechanism**. This is the ability to transfer funds between members of the union in response to economic shocks. A country does this by taxing citizens and redistributing the funds where they are needed.

At present the Eurozone has no fiscal transfer mechanism, although some funding is given to underdeveloped region via the EU Budget (e.g. the Structural and Cohesion Funds).

5) **Similar *business cycles***. This is necessary for a central bank to develop a cohesive policy for the whole region during recessions or periods of growth.

Some Eurozone economies do exhibit a high degree of business cycle synchronisation. However, not all do, and some economies do show quite a low level of synchronisation.[xxxvii]

> ***Business cycles:*** refer to the trend in an economy to move from a period of growth to a period of contraction. Despite being termed a 'cycle' such movements are not usually predictable.

6) **Similar economic structures**. EMU members' output (the amount they produce) needs to be the result of similar economic sectors. For instance, the countries in the EMU must have similar outputs from the service, agriculture, financial sectors, etc.

The Eurozone's suitability is mixed in this regard, some members' economies display high levels of convergence in terms of structure, but there are many incongruities; for example, France has a much larger agricultural base than Germany, which has a larger manufacturing base.

7) **Integrated goods markets**. Economies that have a high level of trade with each other are better placed to integrate. [xxxviii]

The Eurozone does reasonably well in this regard, although there is debate about whether intra-EU trade has grown since the adoption of the EMU (see p.8), and about the extent to which trade in goods and services is integrated as a percentage of overall GDP.[xxxix]

The fact that the Eurozone does not fulfil Mundell's criteria in many respects, suggests that it is a 'suboptimum' currency area. There is, however, much debate about what this means for the future of the Eurozone. Some commentators suggest that it means the Eurozone is unviable, others say it simply shows that the Eurozone needs further fiscal and redistribute reform to become an optimum currency area.

The key question is: did the problem of 'sub-optimality' make the recent Eurozone crisis inevitable, or were other, perhaps avoidable, factors to blame?

The structure of the Eurozone: did it cause the crisis?

Some argue that a 'sub-optimal' EMU will always be subject to crises because it doesn't have a central body to direct activity. They argue that the Eurozone has a ***'coordination problem'*** and that the Eurozone crisis was inevitable because it doesn't have the political structures to coordinate member states' economic actions by setting rules to prevent countries from pursuing their self-interest in damaging ways. Below is a list of problems that amount to a 'coordination problem' in the Eurozone.

> ***Coordination problem:*** arises if a group could benefit from cooperation but they instead, for their own gain, choose not to cooperate.

1) **Excessive borrowing**. When not coupled with economic growth, excessive borrowing can make government debt dangerously large (a lack of growth makes it harder for borrowers to pay back loans and interest). In the Eurozone, governments can sell bonds to investors with the implicit guarantee that the ECB and other

Eurozone states will pay the debt if the country defaults. The ECB and Eurozone states support the guarantee because they would not want investors to think the Euro is a weak currency, and the implicit Eurozone guarantee encourages investors to buy bonds. However, this means that countries can borrow money (through selling bonds) when they have little chance of paying it back. In recent years, therefore, countries have been able to borrow 'cheaply' and excessively.

The German Chancellor, Angela Merkel, faced a political backlash during the Greek bailout, as many Germans felt that Greece had been allowed to borrow too much money without its economy being able to grow enough to pay the money back, due to the implicit Eurozone guarantee.

2) **Conflict over who is responsible for bank bail-outs**. In a sovereign state, this responsibility clearly lies with the national government that controls the central bank. However, no such clear line of responsibility exists in the Eurozone. For example, some banks' survival might be considered necessary to ensure wider financial stability, but depositors in one country would undoubtedly feel unhappy about bailing out important banks in other countries.

3) **Problems when separate countries pursue different *macroeconomic policies*** (this may be particularly apparent between developed and underdeveloped countries). Some countries may want to promote growth by lowering interest rates and, in doing so, increasing inflation. However, other countries may want to keep inflation low to ***consolidate growth***.

This problem may get worse as the EU admits more members into the EMU from eastern and north-eastern Europe. For example, Estonia is due to join the Eurozone in 2011.

Macroeconomic policies: attempt to influence the whole economy (as opposed to microeconomic policies which attempt to influence one part of it).
Consolidating growth: when a country decides to reduce spending and borrowing so that the growth achieved can be supported by a reduction in the country's deficit and debt.

4) **National economic growth occurring at a faster rate in one country than in other countries**. If a country's economy grows and demand increases, prices will rise and supply will be encouraged, which will reduce demand. This process may be accompanied by an appreciation of the country's currency. If a country's currency appreciates, imports from countries with weaker economies - whose currency has not appreciated at the same rate - will be more attractive. This would allow weaker countries to increase their output, which would appreciate their currency. However, this process cannot occur in the Eurozone because there is a single currency rate. The result is that the single currency may not suit members of the EMU because the natural mechanism of currency movements cannot operate to help redress imbalances in trade and the internal economy.

Some countries may benefit from using the Euro in the short term, as perhaps Germany has done. However, Germany has been criticised for supporting policies that closely linked the value of the Euro to its own trading needs (i.e. its high-quality export industry), while not favouring other countries in the Eurozone.

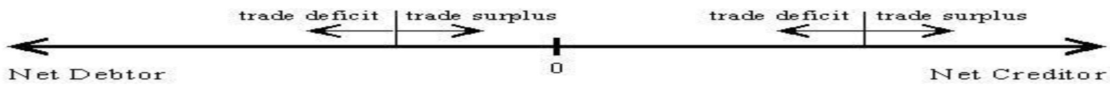
5) **Trade imbalances**. A ***trade imbalance*** is a surplus or a deficit (see the explanation box below on p.13 for a detailed explanation). A trade deficit occurs when the value of a country's imports exceeds the value of its exports. A trade surplus is when the opposite occurs. When applied to the Eurozone, this is a problem because countries cannot control their monetary policy to attempt to redress this balance (e.g. by devaluing its currency to make exports cheaper). Some people argue that trade imbalances are normally self-correcting; when a country runs up a trade surplus it creates international demand for its currency because it is viewed as a good investment. This would lead to the currency appreciating, which would make its exports less competitive, and in turn the country will begin to lose its surplus. Other countries would then increase their exports as they have a weaker currency and so the process begins again. However, some argue that this self-correction has not occurred in the Eurozone because of the single currency.

Trade Imbalances

There has been much discussion about the problems posed by trade imbalances, yet it is important to have a fuller understanding of what causes a trade imbalance and why, in some situations, it is a problem.

There is no simple rule for trade imbalances. It is not the case that trade deficits are bad and trade surpluses are good, or indeed vice versa. Identifying when a trade balance is good or bad depends on the conditions in the country. For example, it might be good for a country to run up a deficit to improve its infrastructure or living standards. Conversely, it might be good for a country to create a surplus in order to tackle its public debt. In effect, a prudent government should manage its trade balance by carefully considering the country's economic circumstances. When a country runs a trade deficit, its spending (imports) exceeds its income (exports), to finance this deficit it must borrow or sell productive assets, that is, it must either borrow money or sell its debt (to someone who sees the debt as a good investment). The ease at which a country can do this is influenced by its International Investment Position (or International Asset Position); this position can be positive or negative. It is positive when foreign assets held by a country exceed the domestic assets held by foreigners. A positive position means that the country is a creditor nation and a negative position means that the country is a debtor nation. A country can influence their position by running a trade deficit or surplus. This is demonstrated in the diagram below:

Figure 1
International Asset Positions



To understand whether it is a good idea for a country to run up a deficit or a surplus we must consider their International Investment Position. There are thus four possible scenarios:

Debtor nation running a trade deficit. This position can be dangerous if the country does not have high growth prospects because growth allows the country to pay off its debt and so retain, or improve, its International Investment Position. If a country is unable to pay off its debt, then its International Investment Position will deteriorate, which will make future borrowing more difficult. Greece perhaps exemplifies such a case; due to its slow growth and trade deficit (in 2009, Greece's imports were worth $64 billion, its exports were worth $21 billion) its International Investment Position has deteriorated and arguably led to its recent inability to service its large debt.

Debtor nation running a trade surplus. This can be the case during periods of growth when a nation that previously ran a prolonged deficit (and in doing so became a debtor nation) begins to run a surplus to improve their International Investment Position. In this case the success depends on its level of growth; if a country can grow it can service its debts. This scenario often occurs if a country has run up a trade deficit to improve its infrastructure, the resulting economic growth from this improvement can then be used to service the debt previous incurred.

Creditor nation running a trade surplus. This can be beneficial as it gives a nation the option of spending more on domestic investment to raise living standards and perhaps improve infrastructure. However, a country could decide not to increase investment if it expects to have to meet increasing financial commitments in the future. Germany is a good example of such a country. Germany has been criticised for its trade surplus and its seeming unwillingness to stimulate domestic demand (in 2008, Germany's exports totalled $1.5 trillion and its imports totalled $1.2 trillion). However, Germany could argue that it is being prudent in light of its increasing welfare commitments.

Creditor nation running a trade deficit. This perhaps is the least worrying of situations and may suggest that a previous trade surplus is being spent by a nation. This may occur if a country has decided to stimulate growth through large infrastructure projects or if it is meeting the costs of other domestic spending.

The scenarios outlined above describe some of the different situations where a country runs up a deficit or a surplus and when this can be beneficial or harmful. In relation to the debate about the Eurozone, it is useful to examine the current balances of trade:

Country	1998 Trade balance (as a % of GDP)	2008 Trade balance (as a % of GDP)	Change (+/-)
Germany	-1.3	6.7	+5.4
Spain	-2.9	-9.7	-6.8
Greece	-3.6	-14.6	-11
Ireland	-0.6	-5.2	-4.6
Portugal	-7.2	-12	-4.8

Source: *Eurostat*

Since the creation of the Eurozone, all Eurozone countries listed above (except Germany) have seen an increase in their trade deficit as a percentage of their overall GDP.

It is clear that governments in some countries (in particular, Greece) have run up inappropriate trade imbalances that have seriously undermined their International Investment Position and their economy. Greece's trade deficit has come under close scrutiny and it has been argued that Greece was unable to deal with its deficit during the recent crisis because it cannot devalue its currency to stimulate its exports.

Finally, it is also worth noting that other factors influence trade deficits and that countries may have further options to manage their deficits beyond devaluation (such as improving their prospects for growth through infrastructure spending). In this sense, the loss of monetary independence may not result in an inevitable crisis. However, it is also evident that some countries may not deserve the criticism they receive for their trade imbalance, for instance Germany might argue that given its ageing population, a trade surplus provides it with a useful safety net for the future.

Other factors which may have contributed to the Eurozone crisis:

The factors listed below detract from the claim that the Eurozone crisis was inevitable. Rather than suggesting that the crisis resulted from a coordination problem in the Eurozone, these factors could be used to argue that the crisis was the result of errors that could have been avoided.

1) **'Stabilising' elements of the EMU were not rigorously enforced or adhered to.** It has been argued that the Eurozone crisis could have been prevented if the Stability and Growth Pact rules had been strictly enforced.

   In June 2010, the ECB Chief, Jean-Claude Trichet, blamed Germany and France for contributing to the Eurozone crisis by breaching the EU's Stability and Growth Pact rules in 2004. However, to date, all Eurozone countries have either broken the SGP (according to figures published by Eurostat), or will break it in 2010 (according to the most optimistic forecasts by the European Commission).[xl] Some people argue that this proves the SGP rules are unworkable.

2) **The role of the ECB**. By underwriting loans to countries that would not be able to pay them back, or by setting interest rates low, to encourage investment and job creation, the ECB may have encouraged excessive borrowing.

3) **The global financial crisis**. It is also important to remember that some of the problems faced by the Eurozone were caused by problems in the wider global economy and financial system. This may suggest that individual states' financial regulation was partly at fault, and so full blame cannot be levelled at the EMU.

4) **Countries borrowed too heavily** and invested the borrowed money unwisely. Countries borrowed money whilst not using the funds to improve infrastructure and other elements of their economy that could improve growth and ***competitiveness.*** This created debt that could not be paid back.

Competitiveness:

A country's competitiveness is an indicator of how attractive a country is to do business in. Factors that affect competitiveness include: taxation, business regulation, labour laws, etc. The table below show how 5 Eurozone countries rank in terms of their competitiveness.

Country	Competitiveness position in 2001	Competitiveness position in 2009	Change (+/-)
Germany	4	7	-3
Spain	23	33	-10
Greece	43	71	-28
Ireland	22	25	-3
Portugal	31	43	-12

Source - *'Global Competitiveness Report' published annually by the World Economic Forum.*

The countries facing the greatest decline in competitiveness are Spain, Greece and Portugal. It is important to realise that this decrease in competitiveness is affected by changes outside the Eurozone (growing competitiveness of non-Eurozone countries for instance) and so does not chart the regression of these countries in relation to other Eurozone countries. However, it is clear that decreasing competitiveness is a serious problem for some countries and that the Eurozone may not have produced the benefits (at least in terms of competitiveness) that some expected. This may be evidence that some Eurozone countries have not enacted sufficient economic reforms whilst running up trade deficits (therefore reducing their competitiveness and growth prospects).

Authors: Stephen Clarke and Claire Daley, 10/2010

The future of the Eurozone

Commentators, politicians and academics widely disagree on the future of the Eurozone. For ease of understanding, this section below divides the debate into two sides; first, there are some people who advocate reform of the Eurozone, and secondly, some people call for it to disband. (Within these two sides there are disagreements, which are highlighted below.)

In order to examine where the Eurozone should go next, the following section picks out the main problems faced by the EU's EMU, as mentioned in the discussions above:

1. **the lack of competitiveness of some Eurozone countries;**
2. **trade imbalances;**
3. **annual deficits and public debt;**
4. **exposure to *sovereign debt*.**

> ***Sovereign debt:*** when the debt of one country is held by someone else in the form of a bond. The country that issues the bond is the underwriter of the bond in the event of a default.

As a result of these problems, the fates of the Eurozone countries are intertwined: if one member defaults on its debt, others will be affected; if one member runs a trade surplus it may mean another state has to run a trade deficit (as long as trade is between these countries); improvements in competitiveness for one country can be the result of reduced competitiveness in another. Because of this interdependence between Eurozone states, responses to these problems are not simple or uncontroversial, yet whatever response is taken will have important implications for the future of the EU and its EMU. Some proposals for dealing with the crisis are given below, and the problem that it attempts to solve has been **highlighted**.

The following section discusses implications of the proposals for both Eurozone and non-Eurozone members because the future of the Eurozone is relevant across the whole of the EU. For example, all new members of the EU must join the Eurozone when they meet the required criteria. Furthermore, whilst the situation is more complicated for those EU countries that have secured an 'opt-out' from the EMU, decisions about the future of the Eurozone do affect these countries both directly and indirectly.

Arguments for reforming the Eurozone

1) **The political argument:** the Eurozone needs more political integration to give EU bodies greater economic control over Eurozone states, i.e. to establish more coherent economic governance between member states.

Proposals:

- **i.** To create a full fiscal union with common taxation. Some claim the Eurozone will only be successful if all Euro countries give up their financial sovereignty and pool resources by setting up common taxes and budgets.
- **ii.** A fiscal union would need to be coupled with a closer political union with central institutions that have the power to give binding macro-economic instructions to member states. This would enable a central authority to transfer funds to countries that need them, **improving competitiveness** which would be **good for future debt levels.** A central authority with expanded powers could be able to respond to any future problems.

Proponents:

- ***i.*** Greater political integration is supported by some left-leaning European politicians, who call for more emphasis on ***'community' decision-making*** in the EU. France proposed closer political integration as part of its interpretation of 'economic governance'.

> ***Community decision making***: where decisions are made unanimously through building consensus, rather than by taking a majority vote.

(NB. Many countries oppose further political integration.)[2]

2) **The rules and sanctions argument:** the Eurozone needs new economic rules backed up by effective ***political and economic sanctions***.

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[2] At an EU summit on 17 June 2010, the British Prime Minister, David Cameron, secured an 'opt-out' for Britain from any further economic integration. This means that whilst the EU Commission had proposed to have the power to review the budgets of all EU member states, the British Government retains primary authority over the UK's budget.

Proposals:

i. The main idea is to create stricter sanctions for countries that break debt and deficit rules. This would have to be coupled with a more effective centralised statistical service to detect when rules have been broken. The benefit of enforcing debt and deficits rules is that, in the long term, it could produce **more stable levels of debt** by preventing countries from accepting low interest loans, backed by the ECB, without worrying about their ability to pay the money back.

> ***Political and economic sanctions:*** punishments for rule breakers. For example, governments that break the SGP rules on debt and deficits could lose payments from the Common Agricultural Policy (CAP) or face a ban on borrowing. Greater political sanctions could include a ban on voting rights or excluding states from certain EU or Eurozone discussions and decisions.

ii. Another suggestion is that states' current account deficits and surpluses should be restricted. This would **prevent dangerous trade imbalances** from threatening the stability of the Eurozone.[xli]

iii. Much of the economic turmoil in recent years has been viewed as a result of a lack of regulation of the ***financial industry***. As a result, some EU countries (most notably France and Germany) have been pushing for more regulation and the banning of financial practices that they deem economically dangerous. The benefit of stricter regulation is that it may prevent European banks and governments from being exposed to bad debt, **including sovereign debt**.

> ***Financial industry:*** organisations that deal with the management of money.

Proponents:

i. Those who support this argument point to errors in Greece and Bulgaria's economic predictions as evidence that rule-breaking and the incorrect disclosure of statistics prevented the crisis being dealt with earlier. (In 2004, the Greek Government admitted that its deficit has not been below 3% since 1999, as EU rules demand.)[xlii]

ii. An emphasis on rules and sanctions is linked to the German notion of 'economic governance' and to some proposals put forward by the ECB.

iii. The EU Commission proposed that the European Parliament should review all EU states' national budgets (not just Eurozone ones), before they are agreed by national parliaments. This was strongly opposed by the UK. There have also been calls by some Members of the European Parliament (MEPs) for the ECB to have a greater role in assessing member states' finances. In contrast the ECB has suggested creating an independent fiscal agency - working within the EU Commission - to do this job.

iv. In May 2010, Germany announced a temporary ban on naked short selling and naked ***credit default swaps***. Germany's Chancellor, Angela Merkel, commented that 'the speculators are our adversaries'.[xliii] The UK is particularly of this type of ban due to the size of its financial sector and concern that overly restrictive regulation would have a negative impact on the British economy.

> ***Credit default swaps:*** derivatives that pay the buyer face value if a borrower, a country or a company, defaults. In exchange, the swap seller gets the underlying securities or the cash equivalent. Traders in naked credit default swaps buy insurance on bonds they don't own.

The problem with many of these rules or regulatory changes is that they **do not address the issue of competitiveness**. Economic growth will be vital for the Eurozone to be able to compete with emerging economies, and growth can only occur if there are important changes to many of the Eurozone economies.

3) The economic reform argument: it would be a mistake to dismantle the EMU because it will be easier to complete the economic reforms that are needed if countries remain in the Eurozone.

Supporters of this argument state that dismantling the EMU (to enable states to deal with the problems faster by devaluing their currency, making their exports more attractive) wouldn't sufficiently solve the current problems. Their ***criticisms of devaluation include***:

i. Some people argue that devaluation is more effective when a country exports a lot of goods. Therefore, devaluation wouldn't help Greece and Spain who have only seen a small increase in their exports relative to their imports, since 2009.

ii. Other critics of devaluation argue that it often leads to inflation, which would cancel out the advantage of increased exports because the costs of production in the country would increase.

iii. Furthermore, **countries attempting to reduce their debt after devaluation** would find that **the burden of debt had increased** because tax receipts (the amount collected from the population) and trade surpluses would be in the devalued currency, whereas the foreign debt would be in Euros. This problem could be solved if growth was particular strong; however, growth prospects are not particularly good in some Eurozone states at the moment because they lack competitiveness.

iv. For a devaluation to be effective wages must be frozen, imports must be restricted and the budget deficit must be tackled. These measures can counter the effect of inflation, but are difficult to enforce or achieve both politically and economically. The Greek devaluations in 1983 and 1985 were not successful and were prevented from being disastrous by controls on capital (to prevent capital 'fleeing' out of the county to escape the loss of value when they were converted into the devalued currency), which would not be permissible now.

Proposals: Supporters of this argument argue for ***the need to focus on economic reform***:

i. The **problem of competitiveness** would be more effectively solved through economic reforms and infrastructure development than devaluation. Proponents of this view point to the improvements that could be made to the single market such as; deregulation to improve cross-border trade in services, ending the protection of sectors such as health, agriculture and energy, and reforming patent and labour laws.[xliv]

ii. Those who support conducting reform inside the EMU argue that it is **incorrect to focus on trade imbalances.** Instead, reforms should focus on **improving competitiveness** because only this can help countries **tackle their debt**. Proponents of this view also argue that trade balances are not particularly important because the Eurozone states are part of the global economy - Eurozone countries could all run up surpluses if countries outside the Eurozone ran deficits, so focusing too much on the German trade balance is incorrect.[3]

iii. Supporters of reform inside the Eurozone see it as a **protection from sovereign debt defaults.** Within the Eurozone, countries have access to funds (the new EFSF fund for instance) that can help them pay back some of their debts and the growing interest, until growth allows them to fully pay off their debts. They insist that any **debt restructuring** would only be possible if countries remained inside the Eurozone, otherwise the countries may as well just default on their debt. Furthermore, some commentators have argued that preventing countries from 'taking the easy way out' and devaluing would provide the only way to force those countries into important, yet difficult, structural changes that will make them **more competitive** in the long term.

iv. These proponents also criticise the idea of an 'internal devaluation', where a country fixes wages and prices to makes exports more competitive. This, they argue, reduces the ability of countries to service and eventually **pay off their debt**.

*Proponents***:**

i. Despite its huge problems, Greece has had success in deregulating some of its most inefficient industries, such as transport, and has successfully faced down protests from workers in these sectors.

ii. According to the *Global Competitiveness Report*, many Eurozone states could become more competitive and, for reasons given above, this is better attempted whilst remaining within the Eurozone because it could produce greater economic benefits than devaluation.[xlv]

iii. Many economic reforms could be relatively cheap as they involve deregulation and the reduction of inefficient subsidies, rather than increased government spending.

4) The agnostic argument: that a break-up in the next few years would be economically disastrous.

*Proposals***:**

i. Proponents of this view argue that, if the Eurozone were disbanded, output in the Eurozone would fall between 5% - 9% and the Euro would lose value against the dollar (reaching lows of \$0.70 to €1.00). This devaluation could cause demand in the Eurozone to fall, which would then cause exports from outside the Eurozone to suffer (as Eurozone states import less), **distorting the balance of world trade.**[xlvi] The wider economic fall-out would **cancel out any improvement in competitiveness** and **make servicing national debt extremely difficult**.

[3] There is evidence that Germany has benefitted from the Eurozone's interest rate because it has caused German wages to rise relatively slowly in comparison with other Eurozone countries, which has improved German competitiveness.

ii. Others suggest that the obstacles to disbanding the Eurozone are not economic but procedural, and that converting contracts back into the domestic currencies would be implausible and financially disastrous (prompting a run on banks and bond markets in the withdrawing country).[xlvii] This would leave the country devoid of the investment **necessary to improve competitiveness** and **service its debts**.

5) **The argument against further *expansion of the Eurozone:*** some people accept that the Eurozone may not be disbanded (some accept this regretfully), but they argue that it should not be further expanded.

Proposals:

i. The Eurozone should not admit any more members until they are fully economically converged with the strongest Eurozone countries. This is based on the idea that it is harder for states to converge with the 'core' Eurozone countries once they are members of the Eurozone (because they cannot pursue an independent monetary policy). Before joining the Euro, countries can use their monetary independence to **improve their competitiveness** (using exchange rate controls to attract investment), and **tackle debts** (by running up a trade surplus).

Expansion of the Eurozone: occurs as more states join the Eurozone. Estonia is due to adopt the Euro in 2011. Countries that join the EU in the future must also join the Eurozone when they meet the required conditions (the *'convergence criteria'*), such as low and stable inflation, exchange rate stability and sound public finances. However, Denmark and the UK have secured an 'opt-out' from the Eurozone.

Proponents:

i. Vaclav Klaus, President of the Czech Republic's work *The Future of the Euro: An Outsiders View* strongly argues against membership of the EMU for the Czech Republic because he believes that, in the long run, membership of the Eurozone would slow its economic development.[xlviii]

Argument for disbanding the Eurozone

Some analysts believe that the Eurozone will never fulfil the OCA (optimal currency area) criteria, and so should be dismantled. These analysts suggest that disbanding the Eurozone would solve many of the problems listed above.

Proposals:

i. **A lack of competitiveness** could be dealt with faster outside the Eurozone because countries could devalue their currency and so make their exports more attractive. Monetary independence would also allow countries to set appropriate interest rates to encourage saving or promote investment. For example, in 2008 it was predicted that if Portugal were to continue to improve its competitiveness at the rate projected for 2007-09, it would still take 22 years to return to the level of competitiveness it had before it joined the EMU (and this was before the full ramifications of the current crisis were considered).[xlix] Therefore, for some countries, the problems of competitiveness are too big to be solved through reforms within the EMU alone and devaluation is a necessary, if not sufficient, condition for increasing competitiveness. Furthermore, devaluation could decrease the ability of countries to import goods, and so countries with trade deficits, such as Greece or Spain, would be forced to stimulate the production in domestic industries in order to cover the fall in imports. Having cheaper currencies could also make the countries more attractive tourist destinations.

ii. **The problems of trade imbalances would also be solved**. The devaluation and accompanying increase in competitiveness would allow countries to tackle their trade deficit and, in doing so, **reduce their public debt**. This idea is related to the theory that trade imbalances are self-correcting when currencies float (see the explanation box on p.10).

iii. Disbanding the Eurozone could improve the stronger economies in Europe**, allowing them to rebalance their economies.** Germany sees its trade surplus as evidence of its prudent economic policy; however, there is no doubt that Germany's surplus was increased by the relative reduction of its wage rates in comparison to the rest of Europe. This has reduced consumer spending in Germany. Disbanding the Eurozone would allow the German currency to appreciate, which could in turn reduce its **public debt burden** and perhaps improve German living standards. Furthermore, it would cut some of the ties between the German economy and other European economies. German voters may support this approach before Germany is forced to bail out another failing economy to its own detriment. This would reduce German exposure to future **sovereign debt default**.

Authors: Stephen Clarke and Claire Daley, 10/2010

Proponents:

i. Many supporters of this view appreciate that disbanding the EMU could produce a great deal of economic problems for all the Eurozone countries, especially countries that were significantly weakened by the global financial crisis. However, some use the analogy of a gangrenous leg to justify such action: it is better to disband the Eurozone now than face more, possibly lethal, problems in the future. Complimenting such a view is the proposal that it may be possible to offer aid and assistance to some of the ex-Eurozone countries after disbanding. Aid would soften any losses incurred by **sovereign debt default** and ease the hardship necessary in **tackling the public debt and trade imbalance**, it would also allow countries to invest in infrastructure and other reforms to **improve competitiveness** in the future. Another way the problem could be addressed is if the debt was restructured so that short-term, high-interest loans were replaced with long-term, low-interest loans.

Conclusion

The Eurozone is the most adventurous economic endeavour the world has seen; never before have so many diverse and large economies been integrated both monetarily and economically. As result, the Eurozone's future has huge implications for economic theory and practice. It is perhaps safe to say that the Eurozone is at a crossroads, where European economic integration is set to increase or perhaps fatally stall.

There seem to be a number of paths that the Eurozone could take. First, Estonia's impending accession to the Eurozone (in 2011) could prove to be the last for a while if Eurozone leaders lose the stomach for greater integration in the face of continuing economic problems. Secondly, the current economic problems could encourage the EU to push for further political and economic integration, tying the political structures of the EU with the economic system of the EMU. This could happen if national governments see it as a way to shift responsibility away from themselves in the event of future economic problems (including trade imbalances, dangerous levels of debt and lack of competitiveness). Thirdly, if member states cannot agree on a suitable reform program, or if the economic conditions proposed by some members are unworkable for others, the Eurozone could disband or devolve into separate, smaller 'Euro zones' (e.g. a Mediterranean, a Central European, and a Baltic version). Those who support the establishing of smaller 'sub-zones' argue that each zone might be more suitable for the economies that comprise it, and therefore could ease the tensions that arise in the bigger, single Eurozone. This advantage, however, would depend on the competitiveness of states within each sub-zone being more comparable, for example in terms of their economic structure, export performance, import dependency, etc.

There have been suggestions that the Eurozone is on the way to economic recovery (e.g. the value of the Euro rose to a 3-month high against the dollar in August 2010). However, this recovery may be just the 'calm before the storm' with many states due to implement austerity measures from 2011. Furthermore, economic recovery may only exacerbate the divisions in the Eurozone if countries recover at different rates; there are already signs that Germany is witnessing a return to economic growth, while Greece has yet to witness any significant improvement in growth prospects and Spain struggles to deal with massive structural problems. This suggests that the recovery could yet be two tiered, and could threaten an already battered sense of unity within the Eurozone. The picture, both economically and politically, is thus not clear, and the future of the Eurozone is still in doubt.

Quotes

'If at this point, given how it's failing, Europe isn't capable of making a united response, then there is no point to the Euro.' French President, Sarkozy, EU Crisis Summit, 2010

'*We will defend the Euro, whatever it takes.'* EU Commission President, Barroso, press conference 2010

'If Greece goes under, that's a problem for the Eurozone. If Spain goes under, it's a disaster.' Nouriel Roubini, Economics Professor at New York University

'How many more fiascoes will it take before responsible people are finally convinced that a system of pegged exchange rates is not a satisfactory financial arrangement for a group of large countries with independent political systems and independent national policies?' Milton Friedman, 1992

Authors: Stephen Clarke and Claire Daley, 10/2010

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