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Piggybacking Pigs.

The future of Euroland after the Greek crisis

Abstract

An unprecedented crisis has recently hit Greece and other countries of the Eurozone, thus raising the question of the functioning of the single currency. 10 years after its introduction, the assumption that monetary union would automatically bring convergence does not appear to be fully confirmed by data. Indeed, macroeconomic imbalances can be seen in a number of countries and national misbehaviours are jeopardising the entire Eurozone.

Political union seems to be a first-best solution to let the Euro work at full speed. Unfortunately, it is not a viable option in today's Europe. Thus, the Policy Brief lists five concrete measures which would help avoid similar crises in the future. These measures imply a reformed Stability and Growth Pact, better surveillance, mechanisms delivering orderly defaults, the introduction of an expulsion clause and the strengthening of the Eurozone external dimension.

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The European Treaties, the Stability and Growth Pact and the very Statute of the European Central Bank are marked by the same "original sin": the belief that monetary union would bring convergence. Political union is not supposed to be necessary and the risk of default in the Eurozone is not taken into consideration, as these are clearly inconsistent with the assumption of "inevitable" convergence. But one should wonder whether the euro has really succeeded in delivering such convergence in Europe.

As will be shown below, the current Greek crisis (or PIGS crisis) should not be interpreted as an extraordinary event but rather as a consequence of the "original sin" of the euro. Therefore, concrete measures – including institutional changes – are required in order to avoid similar crises in the future and, ultimately, to let the euro work at full speed.

10 years of the euro: convergence or fragmentation?

In the first ten years of the euro, strong assumptions of monetary union with convergence seemed to be confirmed by some indicators, interest rates probably being the most relevant[1]. But prices also showed positive track records both in international and historical comparisons. The 2.3% inflation rate in the Eurozone from 2000 to 2008[2] was a stunning achievement, especially when compared to the previous decade's data and to US inflation in the same period.

Clearly, these results were possible thanks to the solid monetary policies pursued by the European Central Bank (ECB), which gained high credibility in the international markets. Furthermore, the euro contributed to financial integration and to the development of the Single Market. However, further progress is still required in both cases. For instance, as Daniela Schwarzer puts it, «labour

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[1] In 1995 the average interest rate of 10-year bonds issued by Portugal, Italy, Ireland, Greece and Spain was 12.1%, around 40% higher than the equivalent rates in France and Germany. This difference was only 2.1% in 2003 (but in recent years it increased up to 10.4% in 2008). Eurostat Database.

[2] Harmonised Indices of Consumer Prices (HICPs) for the euro area (16 countries), Eurostat 2009.

markets remain fragmented: a high degree of cross-border labour mobility is unlikely to occur within the EMU while wage bargaining and social security systems maintain their historically grown national specificities. As long as these fragmentations persist in the EMU, markets only function insufficiently. As a consequence, asymmetric shocks will not be compensated effectively, resulting in a reinforcement of regional economic cycles»[3].

More importantly, positive results at the EU level risk hiding great differences between member states which, on the contrary, form the picture of a fragmented and unbalanced Eurozone. Setting average productivity in the Eurozone from 2000 to 2008[4] to 100, Greece showed very bad performance (only 68.9). Also, data on average Greek inflation were not in line with the Eurozone in the same period (3.4% versus the above-mentioned 2.3%). Negative performance could also be seen in Portugal (53.1% and 3%), Spain (89.6% and 3.3%) and Italy (92.4% and 2.5%). But the same did not hold true for Germany (109.7% and 1.8%), as it was able to pursue price (especially wage) moderation policies and relaunch productivity.

Such diverging economic performance has an inevitable impact on competitiveness and growth rates. Germany jumped from a current account deficit in 2000 (-35.2 billion euro) to an impressive surplus in 2008 (165.4 billion euro)[5]. Conversely, Greece, Portugal, Spain and Italy recorded comparatively strong deficits (particularly relevant in Greece and Portugal as a % of GDP) and showed low growth potentials. Thus, when suggesting that Greece should make sacrifices to fight the crisis, one should keep this situation in the back of his mind, as the consequences could be a further deepening of the economic downturn and a higher risk of default.

To sum up, economic convergence in the Eurozone has been only partial and probably not in line with expectations. Nevertheless, the basic assumptions of the Eurozone have not been sufficiently questioned or put to the test, at least not until an unprecedented worldwide economic crisis severely hit the Eurozone, thus making change inevitable.

State misbehaviour and European failures

By focusing excessive attention on data from the entire Eurozone and overindulging on constant imbalances in (and between) member states, misleading signals have been sent to the financial markets. In other words, they have been asked to keep an eye mainly on the economic performance of the Eurozone as a whole, rather than on national economic imbalances.

In this context, the economic literature foresees risky consequences in terms of state behaviour: free-riding and moral hazard. Indeed, the cost of out-of-control public accounts and fiscal policies at odds with medium-term budgetary objectives was supposed to be absorbed by the entire Eurozone.

Consequently, this represented an incentive to further laxity in economic policies and less transparency in public accounts and financial operations, as demonstrated by various “shortcuts” taken not only by Greece but also by other EU countries over the last decade (i.e. currency swaps hiding real loans). In a nutshell, these opaque – if not plainly illegal – operations do not represent a bad countermeasure to today’s crisis, but rather the inherent consequence of the basic assumptions of monetary union.

With a view to reducing, if not avoiding, such misbehaviour and averting the danger of moral hazard, the EU has introduced a number of instruments since 1997. The first was the multilateral surveillance procedure i.e. a ‘preemptive’ tool obliging member states to submit Stability Programmes (SPs) to the Commission and the Council[6].

[3] See D. SCHWARZER, *Institutional and Policy Dynamics in the EMU’s Internal Governance and External Representation*, in C. SECCHI and A. VILLAFRANCA (eds.), *Liberalism in crisis? The European Economic Governance in the Age of Turbulence*, Edward Elgar Publishing, 2009.

[4] Labour productivity per hour worked (GDP in Purchasing Power Standard), Eurostat 2009.

[5] Current account transactions, Eurostat 2009.

[6] Pursuant to Art. 121 (4), the Council, following a recommendation by the Commission, can issue an early warning to a member state

These SPs provide information not only on the deficit and debt ratios but also on many other economic variables (government investment expenditure, real GDP growth, employment, inflation etc.) and also include an assessment of the qualitative effects of budgetary measures[7].

In other words, these tools aim at avoiding excessive deficits *ex ante* and are potentially very effective. But they have significant drawbacks; in particular, their Achilles' heel is not only the set of economic indicators under surveillance (e.g. more attention should be attached to private savings, other private sector indices, foreign ownership of national debt etc.) but also the quality of the required information. Not to mention the Commission's limited real power to force a member state to provide more detailed information (including, if necessary, data on specific operations its government has undertaken with international financial operators).

Conversely, the Stability and Growth Pact (SGP) and the excessive deficit procedure are intended to identify excessive government deficits *ex post*, and to provide mechanisms and sanctions which may also lead to the imposition of fines[8]. But one should note that sanctions can be activated only if an excessive deficit occurs, but are not foreseen in the event of other macroeconomic imbalances.

The Greek crisis shows that this European mechanism has dramatically failed to deliver, both in surveillance and misbehaviour correction/sanction terms, for two main reasons: insufficient powers and instruments in the hands of the Commission/Council, and an unbalanced focus on excessive deficits rather than on macroeconomic stability and concrete convergence in the Eurozone.

Moreover, the euro cannot rely on the strong coordination of economic policies that is usually provided by a federal state. Thus, it comes as no surprise that both historical supporters of the euro (e.g. Issing and Padoa Schioppa) and its critics (e.g. Krugman and Soros) have recently agreed on the same issue[9]: it is difficult, if not impossible, to have a successful single currency without a common economic policy.

The conclusions to be drawn from this analysis would seem crystal clear; European countries – or at least Eurozone members – should take advantage of this crisis to put forward what has always been necessary since the creation of the euro: political union.

Helping the euro to work better

The key question is whether political union is strictly required in order to forgive the "original sin" of monetary union. Clearly, this would represent a "first-best solution" which would *de facto* wind up the lack of coordination of economic policies and the negative effects of the "one-fits-all model" adopted for monetary policy.

Nonetheless, one should also consider what political union would imply: the creation of a truly federal budget and a supra-national government with the power to define economic policy and to shift money within Europe to cope with possible asymmetric shocks or bad performance by member states.

A more realistic approach suggests that this is a simply impossible goal in today's Europe. Taking the Greek crisis as an excuse to make a quantum leap towards political union would be not only misleading but also plainly wrong. The socio-political situation in Europe is completely at odds with this view and it is out of the question for all of Europe's political leaders.

However, some have pointed out that such a revolutionary event might take place only after a dramatic worsening of the Greek crisis affecting the entire Eurozone, but even so, one should probably expect

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before an excessive deficit procedure occurs.

[7] See Council Regulation (CE) No. 1466/97 of July 1997 on the strengthening of the surveillance of budgetary positions and coordination of economic policies.

[8] The possible sanctions are as follows: the need to publish additional information before issuing bonds and securities; reconsideration of the European Investment Bank's lending policy for the member state concerned; creation of a non-interest-bearing deposit with the Union, the imposition of appropriate fines (Art. 126 (11) TFEU).

[9] See P. KRUGMAN, *The Making of a Euromess*, in «The New York Times», February 14, 2010; G. SOROS, *The euro will Face Bigger Tests than Greece*, in «Financial Times», February 21, 2010; O. ISSING, *Europe Cannot Afford to Rescue Greece*, «Financial Times», February 15, 2010; T. PADOA SCHIOPPA, *Europe Cannot Leave Athens on Its Own*, in «Financial Times», February 18, 2010.

the complete collapse of the euro, rather than political union. Not to mention the legal constraints related to this view: member states' Constitutions do not allow such a step.

The very ratification of the Lisbon Treaty has raised many problems: in last year's famous ruling, the German Constitutional Court stated unambiguously that macroeconomic policy must remain a German competence.

Therefore, it would be wiser to investigate concrete steps to take in order to improve monetary union, rather than speculating on political union. In particular, the following measures could be undertaken to achieve higher integration in the Eurozone and to set the stage for the effective management of future crises:

1. Reforming the SGP: the Pact was reformed in 2005 to make it less "stupid" and to introduce more flexibility. Unfortunately, the term "flexibility" was interpreted in a very peculiar way. It was mainly meant to make constraints less stringent for member states (especially in the event of an economic downturn), by taking into account "any other factors" which they deemed relevant and extending the maximum time periods back to the Maastricht criteria reference values[10]. Clearly, the new reform should be built upon different assumptions and move in a different direction. The *ex ante* and *ex post* instrument spotlight (SPs and SGP) should not be turned only on state budgetary discipline but rather on a wider set of indicators, allowing for the overall evaluation of macroeconomic imbalances of a member country (in both the public and private sectors) and their impact on convergence / divergence within the Eurozone. Following recommendations from the Commission, the Eurogroup (whose role vis-à-vis the Council needs to be enhanced) should be allowed to indicate targets/actions and, if necessary, impose sanctions on those states responsible for national imbalances or divergence in the Eurozone. These targets should also be consistent with the new Lisbon Strategy (the so-called "Europe 2020"). Thus the Eurogroup, albeit indirectly, would be able to oblige member states to achieve the targets of the new Strategy.

2. Improving surveillance: the Commission should be given more power (in terms of the quantity and quality of information from member states). Moreover, in order to provide more accurate recommendations, the Commission should take into account the early warnings of the future European Systemic Risk Board on the macro prudential oversight of the financial system. In this regard, the Eurozone countries should also strive to overcome the limits posed by the European Council[11] on the legislative proposals setting-up the Board and three Authorities (on banking, insurance, and securities and markets). The Parliament's current efforts to amend the proposals in such a way as to strengthen the role and powers of these new actors should be supported.

3. Managing default: the lesson learnt from the Greek crisis is that default cannot be excluded *a priori* and needs to be managed. In this regard, Daniel Gros and Thomas Mayer have suggested the creation of a European Monetary Fund[12] which may intervene by delivering an orderly default as a measure of last resort (conditionality of support by the Fund would limit moral hazard problems in member countries). Its financing mechanism would be based on contributions given by those countries which breach the Maastricht criteria every year. But this mechanism may also be enlarged to include sanctions (in particular fines imposed by the Eurogroup/Council) for countries with other imbalances (see point 1). In addition, the possibility to issue Eurobonds to at least partially correct asymmetric shocks

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[10] See Council Regulation (EC) No 1056/2005, June 27, 2005, amending Regulation (EC) No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

[11] See European Council Presidency Conclusions, June 18-19, 2009, «The European Council stresses that decisions taken by the European Supervisory Authorities should not impinge in any way on the fiscal responsibilities of member states».

[12] D. GROS and T. MAYER, *Towards a Euro(pean) Monetary Fund*, CEPS Policy Brief No. 202, February 2010.

and finance significant EU projects (i.e. infrastructures) should be given serious consideration. Once again, conditionality of intervention is a key issue (the Eurogroup/Council should have the last word on issuing Eurobonds)[13].

4. Introducing the expulsion clause: a recent ECB paper[14] has made it clear that expulsion of a member country from the EU or the monetary union is not possible under the current EU legal framework (Art. 50 of the Lisbon Treaty only allows for unilateral withdrawal from the EU). Despite all the legal and economic obstacles, potential expulsion from the Eurozone would send a clear political signal to negligent member states that free-riding will not be tolerated. Such a clause should be enshrined in the Treaties and used in the same way as Art. 50, i.e. only if extraordinary cases occur. It would be the ultimate sanction in the hands of the Eurogroup, but in concrete terms it would only represent a method of dissuasion for non-compliant countries (and their citizens). Moreover, in order to avoid the risk of asymmetric application (penalising small countries), a special procedure including an *ad hoc* qualified majority should be provided for when using the clause.

5. Strengthening the external dimension: the European Union needs to strengthen its international role, not only by speaking with a single voice but also, if necessary, with two closely connected voices. Indeed, EU and euro interests at the international level do not necessarily overlap all the time, and adopting a common position in the Eurozone rather than in the EU-27 is both more likely and easier. The target of a Eurozone seat – to be added to the EU seat – in selected international institutions starting with the IMF, should be at the core of the renewed external strategy. Should this strategy be successful, IMF intervention in European countries (including the Eurozone) would be less embarrassing.

In the coming weeks, a solution in line with the EU's traditional compromises will hopefully be found to solve (or probably postpone) the Greek problems. But should the Eurozone be unable to undertake more courageous measures in the medium run, member countries will definitely fail to benefit from the unparalleled economic potential offered by the euro. The simple announcement of such measures – preferably on the occasion of a special EU summit – would also have a positive impact in the short run, and thus help to solve today's PIGS problems.

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[13] See E. JONES, *A Eurobond Proposal to Promote Stability and Liquidity while Preventing Moral Hazard*, ISPI Policy Brief No. 180, March 2010.

[14] See P. ATHANASSIOU, *Withdrawal and Expulsion from the EU and EMU*, European Central Bank, Legal Working Paper Series, No. 10, December 2009.

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