Does the current economic crisis pose a serious challenge to the viability of the euro?

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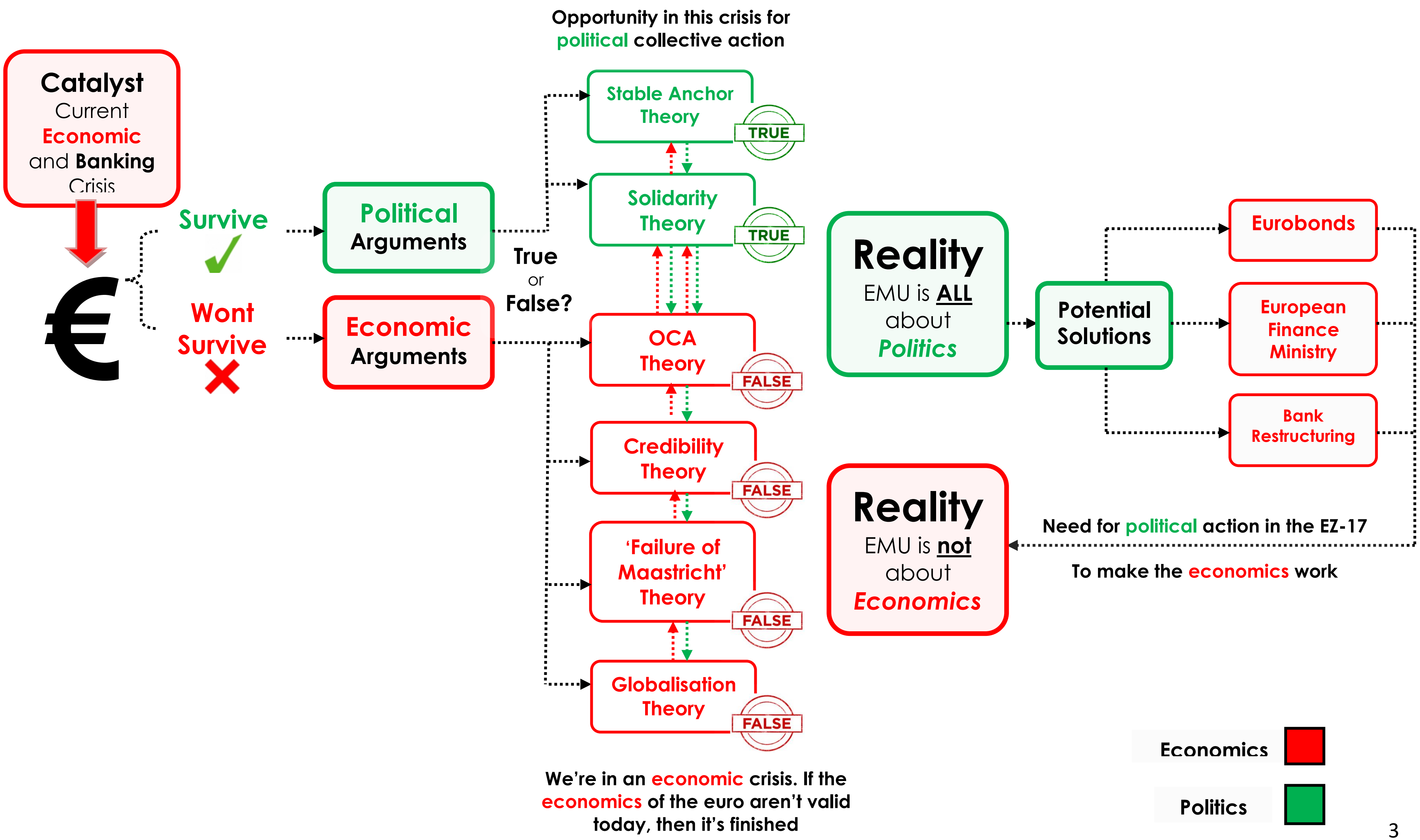
Essay Outline



Introduction

Since the onset of the current banking and sovereign debt crises in the EU, debate over the future of the European single currency has become hugely contentious. In some analyses, hysteria has replaced sound common sense with some commentators actively promoting misunderstanding of the wider European project. The debate over the euro's survival has therefore long become a misguided one based on false assumptions and poorly researched conclusions.

One core fact and often forgotten feature of the euro debate is a lesson freshmen students in European integration learn very early in their studies. The wider European Union (EU) is an artificial political Frankenstein[1] and by natural extension so is its monetary offspring in the form of European Monetary Union (EMU), the so-called eurozone of 17 member nations (EZ-17). What is correct is that EMU, still in its infancy, was always and continues to represent an ambitious risk and an unknown gamble[2] and not just because of tenuous economic rationality. EMU, like its parent, traces its lineage to European politics.

The long term feasibility of EMU (i.e. the euro) lies predominately with a combination of economic and political factors, not one or the other. While the euro in the current crisis bares the hallmarks of an inexact and debt-deficit fuelling economic behemoth, it will likely (belatedly) reassume its role as a political tool to achieve deeper political integration for the European project.

This overview consists of *four* parts:

- **Firstly,** it will provide an overview of the main arguments in favour of and against the euro by the main commentators in this debate
- **Secondly,** it will give an overview of the current dual crises affecting the eurozone and the PIIGS (Portugal, Ireland, Italy, Greece and Spain)
- **Thirdly,** it will analyse and critique the economic and political arguments on sustainability of the EMU
- **Lastly,** it will conclude with an analysis of the political longevity of the euro into the future, possible future plans and comment on the current crisis.

[1] Waterfield, Bruno (2007). '*Belgium, like the EU, is a Frankenstein creation.*' The Telegraph. 3 October, 2007.
[2] The word 'gamble' in this context was first utilised by Barry Eichengreen in a 1996 lecture. (Thom, 1997:19)

Views on the euro

The opinions of commentators on the viability of the euro are quite varied. A sample of opinion on both sides of the debate is given in the following table:

No, it wont last (economic case)	
Detractors	**Verdict**
Albert Edwards Fmr UK Foreign Secretary **Jack Straw**	"…there is little help that can be offered by the other eurozone nations other than **temporary, confidence-giving 'sticking plasters'** ….any help given to Greece merely delays the **inevitable break up** of the eurozone." (Edwards)
Martin Feldstein	"There's too much incentive for countries to **run up big deficits** as there is no **feedback** until a crisis."
Maybe it Will, Maybe it Wont (economic/political case)	
Fence Sitters	**Verdict**
Carlo Favero	"The existence of a common currency has **prevented the emerging growth differentials from being compensated by exchange-rate movements** and therefore countries with more severe fiscal sustainability problems are now experiencing higher unit labour costs and loss in competitiveness that makes the prospects for stabilisation of their public deficits and debt even bleaker."
George Soros[3]	"The euro had no provision for correction. There was no arrangement for any country leaving the euro, which in the current circumstances (Greece) is probably inevitable…we are on the edge of collapse and that is the time to **recognise the need for change**."
Gary O'Callaghan	There is potential for Greece to leave, set up its own parallel currency for small purchases. However the euro would be used too because…" it is not possible to go around Greece and vacuum up the €23bn in banknotes and coins that circulate there. Moreover, there is nothing to prevent Greek banks from continuing to accept deposits and give loans in euro. And the government can still operate in euro" until euro notes drain out through trade deficits (but austerity plan in 2011 of €7bn would still need to go through to fix BOP deficit)
Yes, it will last (political case)	
Protagonists	**Verdict**
Paul Krugman	"….the costs of **undoing the thing would be immense and hugely disruptive**. Europe is now stuck with this creation and needs to move as quickly as possible toward the kind of fiscal and labour market integration that would make it workable."
Jeremy Warner	Too much **political capital invested** in the project for it to fall at the first fence
Barry Eichengreen[4]	"…very, very unlikely… Greece would reintroduce the drachma as part of its debt restructuring and crisis resolution efforts…Europe has so **much invested in the euro economically and politically** that it's not going anywhere."
UK PM **David Cameron**	"The countries that joined the euro have an **enormous amount invested** in it and do not want it to, and will not let it, fail…they see it as an absolute key part of their national interest and identities and I would not doubt their resolve in any way."
Joseph Stiglitz	"The EU, the euro, and the **premise of European solidarity is being tested** again. The measure of Europe will not be in the harshness of its actions but in the spirit of solidarity that it shows in assisting its neighbour."…"the resolution is within Europes grasp."
Richard Baldwin **Charles Wyplosz**	"The real problem of Greece is neither its public debt nor its current deficit. The **problem is wage and price inflation** that has knocked its economy down the competitiveness league tables."
Jacqueline Thrope/Stratfor	"…the Eurozone is fundamentally a political project, the weakening of the **political bonds** that tie Eurozone member states into a currency union are what will ultimately lead to its dissolution or modification…. The Eurozone can and will muddle through the current crisis — it has proven that it has the tools and required flexibility to do so."

[3] http://www.telegraph.co.uk/finance/economics/8599634/George-Soros-says-it-is-probably-inevitable-a-country-will-leave-euro.html

[4] Robinson, Frances (2011) '*Only Solution to Greek Debt is Restructuring*'– Eichengreen Interview.' http://online.wsj.com/article/BT-CO-20110623-709327.html

Commentator's views can therefore be broadly separated into two groups (and a middle 'fence sitter' group), each of which comes to very different conclusions

a) The euro will ultimately fail because the **economic** case for it doesn't stand up
b) The euro will continue because the euro is a **political** tool and has the success of the entire European project as a whole riding on its success – very little to do with economics

(A) Economically, the EZ is doomed and its only a matter of when…

Critics tend to focus on the economic case for EMU using similar and related negative arguments:

- EMU is an arbitrarily regulated patchwork monetary creation with a lack of realistic independence
- The control of EMU is weak, poorly centralised and vulnerable to political interfering
- EMU is poorly resourced, with a lack of financial might backing the whole thing up
- The recent poor performance by EZ economies highlights a breakdown in the law governing the euro (the Maastricht Criteria)

Some commentators have, with good reason, been critical of the institutions of the euro which has caused some to change their original optimistic predictions. As McKay (1999) asserts, quoting Martin Feldstein, at the time of the euro's creation…"EMU could be the most far reaching European political event of the 20th Century." Eleven years later, and Feldstein is scathing in his criticism saying "… [with the euro] there's too much incentive for countries to run up big deficits as there's no feedback until a crisis" (Fleming and Shipman 2010). This means that only when a crisis arises do discussions about fixing the inherent problems begin, a bit like ignoring the warning lights on the dashboard before your car finally breaks down because you don't want to pay for a service. What was wrong with the system in the past, so the prevailing wisdom goes, is now painfully obvious as the EZ struggles with unsustainable debt mountains not helped by reckless expansionary fiscal policies of profligate member nations with no chance of punishment.

Historically, crises of this magnitude have seen economic warfare avoided by restoring the competitiveness of the troubled nation's exports to balance budgets by devaluing the currency in use. Within EMU, the EZ-17 members cannot devalue (make their currencies cheaper against competing currencies, because all the EZ are one currency already!). They are left with only the painful course to restore investor confidence, a medicine of forced deflation through drastically higher taxes, cutting public expenditure and reducing the role and the cost to the exchequer of the public sector (privatisations). The *Société Générale* strategist and commentator Albert Edwards and others point out this problem, previously believing that whatever 'sticking plaster' injection or 'bail-out' may be offered by big euro nations (Germany and France) or by the IMF to the weaker peripheral 'PIIGS[5]', the confidence in the eurozone has already been dented and thus the break-up of the eurozone (either completely or into 'two speed' structures) is now inevitable as the PIIGS economies deteriorate further. The depth of analysis required to formally adjudicate the euro's perpetuity is therefore not as straightforward as some would have us believe.

(B) Politically, the €'s demise is unfathomable and won't be allowed to happen

Other commentators stress the political aspects in their arguments supporting the survival of the euro and EMU. Yes, its economically flawed and has undergone a severe shock but it will ultimately survive for a diverse set of reasons, at least so the argument goes. For renowned economic commentators like Paul Krugman (2010) the immense scale and depth of EMU makes its collapse highly unlikely, if not impossible. While the costs of correcting the current problems are high, the cost of ending EMU would be hugely disruptive both economically to the single market for trade and politically for the collectivist ethos and solidarity of the European project as a whole. In effect the killing EMU would kill the economic raison d'être of the EU as a whole as it would disrupt the market for free intra-EU trade. Warner (2010) and others such as British Prime Minister Cameron carry this argument further opining that the effort and political capital invested in EMU to date is simply too much to be arbitrarily abandoned when the going gets tough.

Important to the political arguments about the euro s survival is the issue of Germany. There is something discernibly (and purposefully) German about the euro. It was German reunification in 1990 that provided the catalyst[6] for such a bold proposal to get legs, taking advantage of a wave of Euro-optimism after the spectacular (and sudden) collapse of communism. Germany, as a founding member and credibility anchor for EMU, historically represents the pinnacle of prudent monetarist policy, the stern headmaster (or head mistress in present day Chancellor Merkel) who teaches his/her students best practice based on decades of experience. Critics therefore spin this fact by equating the euro problems to being a German problem (Giles and Parker 2011). It was German obsession for price stability and strict adherence to fiscal rectitude which formed the fundamental creed for the financial architecture for EMU, with the European Central Bank (ECB) directly modelled on its own federal Bundesbank. Ultimately, the essence of the argument is that the current crisis permeates to the heart of 'Europe' probing the viability of the European project as we know it… that "…the premise of European solidarity is being tested again. The measure of Europe will not be in the harshness of its actions but in the spirit of solidarity that it shows in assisting its neighbour" (Stiglitz, 2010). The problems are domestic (I.e. wage inflation and trade competitiveness) but are, under

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[5] O'Grady (2010) refers to the term 'PIG' nations – referring to Portugal, Spain, Greece and Ireland, nations in the eurozone with the largest Debt/GDP ratios and the weakest public finances.
[6] Sarotte, Mary Elise (2010). '*Eurozone Crisis as Historical Legacy.*' Foreign Affairs 29 September, 2010

the confines of EMU, beyond the realistic capacities of national governments to resolve (Baldwin and Wyplosz 2010). Ultimately this is a situation which mirrors that of post-war Europe and requires a coordinated communal action plan, or mini-Marshall Plan[7] as suggested in some quarters. The difference now is that this represents an exclusively political undertaking, motivated by economic uncertainties unlike its post-war behemoth predecessor which was arguably the exact opposite.

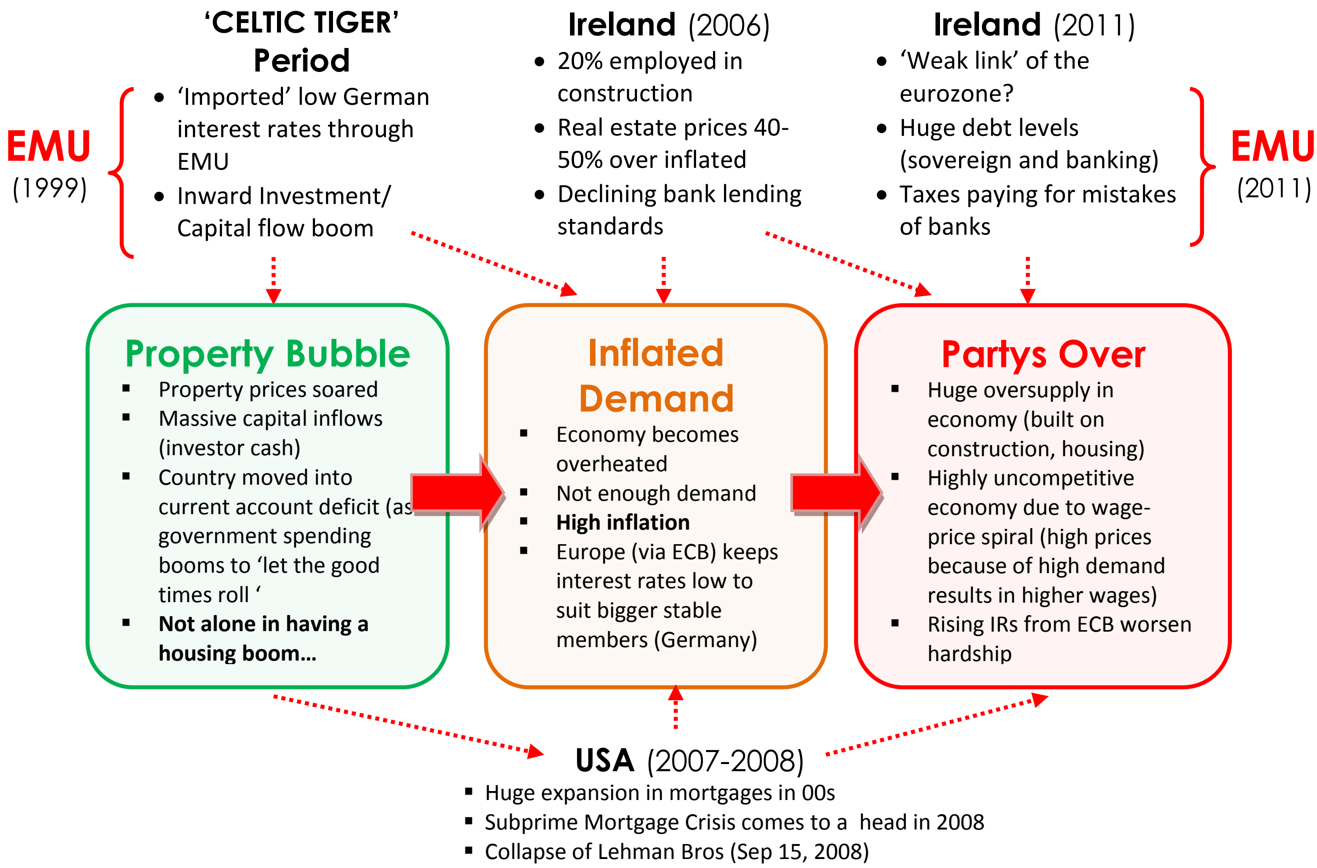
The Dual Crises (Sovereign and Banking)

The onset of the IT digital revolution and a systemic institutional globalisation (spread of common democratic and capitalist values) has made dealing with the dual crises qualitatively different from the past. First, a history lesson. What began as the worldwide competitive regulatory race for the bottom to attract capital from international financial hedge funds and financial institutions soon became a binge on securitised debt and an obsession with profits as price soared. This process akin to a global ponzi scheme was effectively founded on one very unstable predication – that of constant rising prices in the commercial and residential property sector. US banks played a key role. With increasingly lower leverage (the ratio of assets to borrowing) US investment banks gambled, selling NINJA mortgages (**N**o **I**ncome **N**o **J**ob or **A**ssets), to those who couldn't afford them as banks leverage ratios exceeded 20:1 ratio (Lehman hit 44:1). Through a complex web of packaging mortgages and selling 'debt packages', a process known as securitisation, risk was shared around the system. Ultimately, as recession hit, the subprime mortgage crisis hit the United States in 2007. By 2008, this contained crisis was catapulted by the collapse of Lehman Brothers not simply into a global credit crisis that spread doubt and nervousness into the entire Western financial system, particularly affecting the banking sector of countries which had witnessed a property and credit binge in recent years, such as Ireland (See diagram below).

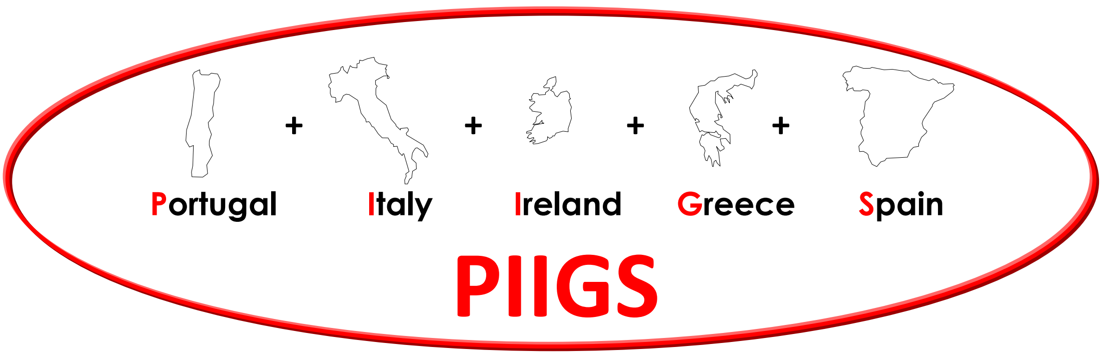
Where money was once virtually cost-free and easily obtainable, conditions changed rapidly amid an onset of belt tightening by worldwide lenders. This, coupled with growing levels of bank insolvency and increasing risk of borrower default, led growth in even once robust economies to nosedive and investor confidence to plummet. Investors, themselves struggling to keep their heads above water, fled for cover, desperately searching for a lifeboat in the form of 'sure thing' investments. This meant dumping the bonds of high risk nations who themselves were already severely weakened, forcing their bonds prices to skyrocket – making financing their obligations next to impossible on the open market. Those economices built on the changing sands of investor sentiment just so happened to be eurozone members - the so called 'bubble' peripheral nations or 'PIIGS' which represented the shakiest props holding up the euro itself. The problem for the eurozone is clearly multifaceted and inherently endemic based on changing economic circumstances in each of the various component economies.

[7] http://www.telegraph.co.uk/finance/financialcrisis/8619241/Germanys-judges-hold-the-euros-fate-in-their-hands.html

EMU and the Irish Property Crisis[8]



The reason why the dual banking and sovereign debt crises have shifted opinion negatively against the long term viability of the euro is based however on a misguided interpretation of EMU as an economic project, the culmination of converging European economies from the days of coal and steel right up to the Single European Act. Its recent difficulties therefore are logically a repudiation of sound economic theory meaning a sharp correction and reduction in the size of the EZ-17 is the solution. However by analysing the four main **economic arguments** currently batted around by commentators as proof of EMU as a badly misaligned and overambitious monster, it becomes obvious that there is more here than meets the eye. Vitally, if the bases of their arguments are built on falsehoods, then their arguments are easily discounted.



[8] Source: Kelly, Morgan (2006) *'How the housing corner stones of our economy could go into a rapid freefall'*. The Irish Times. Thursday 12 December 2006 and Krugman 2010.

The Economic Arguments behind EMU

Two issues matter when using the economic argument against the euro's survival - sustainability and viability. One common misunderstanding is that, with the current European crises forcing a reappraisal of the entire EMU project, the eurozone (EZ) has rational, economically verifiable common sense fundamentals at its core. Critics therefore use the current crisis as proof that the economics are not as strong as they were always argued to be. It may seem surprising that in some respects the 'economics' underpinning the euro have always been relatively spurious. Therefore, in any comprehensive analysis, reference must be made to the euro's perceived economic fundamentals expressed in key main economic arguments - all of which are often misreported and misinterpreted. I will also comment briefly on how the current crisis has exposed the strengths and weaknesses of EMU for each of the formative arguments.

Economic Argument 1: Europe Represents an Optimal Currency Area

The most common error by commentators is assuming European monetary integration began with a strong basis in economic theory, specifically that of optimum currency areas or OCAs (Frieden 2002). According to OCA theory, monetary union is a prudent policy choice for economies/economic areas when they share certain characteristics, as follows[9]:

1. Correlated business cycles
2. Labour market flexibility
3. Similar trade structures
4. Similar levels of openness to trade and intra EU trade levels

However, this theory is widely rejected as a model for causality in the eurozone case (McKay 1999, Eichengreen 1993, Bayoumi and Eichengreen 1994, Eichengreen and Wyplosz 2004). Historically, European monetary systems have been relatively strong, from the Hume price-specie mechanism inherent in the gold standard to the post-war Bretton Woods system. However the pegging regime (where countries fix their currency exchange values to each other to promote stability, known as the European Monetary System or EMS) failed despite its openness to mutual support and coordination (Eichengreen and Wyplosz, 2004: 307). Yet, EMU was a far bigger step forward than anything ever attempted before. But, was it right and timely to take that big leap?

[9] Mundell (1961), McKinnon (1963), Kennen (1969)

Prevailing academic wisdom tends to concur that only the 'core' region (Austria, Germany, the Benelux countries and parts of Northern France) can ascribe their membership to this theory, which conveniently represents the original European Coal and Steel Community (except Italy).[10] Others go a step further and dispute that even the 'hard core' EU nations, that is those clustered around the industrial Ruhr, constitute an OCA (Neary and Thom 1996, Frieden 2002: 836). Limited labour mobility, lack of correlation of exogenous shocks responses and disparate trade patterns produce a very unlikely scenario for currency union. This view adds credence to the view that the EZ-17, being the only example of monetary union without political union has a flawed economic pedigree in relation to the OCA theory.

In either case, the theory as applied to EMU is highly disputed, as empirically evident in statistics. As Eichengreen (1990) and De Grauwe (2003) interpret, the main economic gains of adopting a monetary union are as follows:

1. Lower transaction costs
2. Increased market efficiency
3. Greater economic certainty and ultimately
4. Higher economic growth.

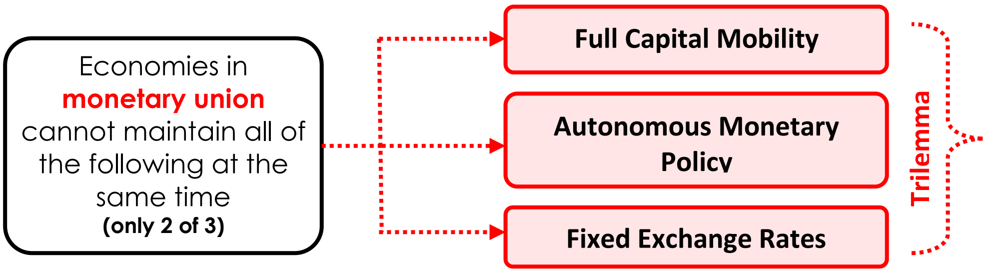
Estimates of savings from transactions costs vary from estimates of 0.25%-1% of EU GDP (EC 1990, Hix 2005). The potential positives related to the removal of uncertainty by 'anchoring' into a fixed exchange rate regime are muted somewhat by the ability of peripheral economies to take advantage of low interest rates to reduce the cost of debt factoring costs and improve expenditure in politically popular areas such as healthcare, education and transport infrastructure. Ironically, nations such as Portugal, Ireland, Italy, Greece and Spain (PIIGS) experienced huge gains from EMU as a direct consequence of this, and thus correctly the theory holds that economic growth in some areas was very robust. Some tangential logic is to this point is that, although "unsuitable non-OCA" countries may indeed form part of the EMU, OCA theory can hold if, through currency union, countries become more linked, evolving as their factor markets become more integrated and their production structures more similar (Frankel and Rose, 1998).

As you've probably noticed, here we see a split in the economic logic. The euro, intended according to the OCA theory as merely an penultimate 'end result' streamlined mechanism for a high (and increasing) level of homogenised trade (solidified by the 1987 Single European Act) morphed into an aspirational 'work in progress' mechanism to enhance and promote convergence where it *didn't* exist (i.e. labour market mobility, trade interdependence etc). Effectively, the euro would be the tool to achieve what OCA theory says should exist in the first instance for EMU to work. This 'tool' contention was utilised by EMU

[10] See **Appendix 1**

advocates prior to its formal recognition in the Maastricht Treaty (1992) in accordance with the Mundell-Fleming framework (Bain and Howells, 2003).

Mundell-Fleming Model



In summary, although OCA theory does **not** apply, economic theory was twisted in the euphoric and promising era in the early 1990s in order to capture and maintain the gains of the internal market through subordinating national monetary policy under the supranational EMU umbrella (CEC 1991, Padoa-Schioppa 1989). The current crisis has brought to the fore several problematic aspects of this framework not least the neutering of national exchequers to combat severe current budget deficits and external debt mountains by devaluation. In this sense, the effort to achieve an OCA (rather than naturally evolve into it) was an obtuse 'one size fits all' effort which benefited the peripheral non-core nations, such as the PIIGS and this had contributed in some measure to the modern day crisis.[11]

Economic Argument 2: Membership of EMU was sought by nations seeking to achieve price stability and anti-inflationary credibility

Another theory underpinning EMU is that which relates to the stabilisation effects of adopting a new **credible** Bundesbank inspired monetary model for the European Central Bank (ECB). The achievement of credibility is as important economically in relation to financial and capital markets as it is politically for governments. It is credible, for example, for private interests to be more inclined to support monetary union and/or a currency peg[12] if it formally anchors an economy with a low inflationary regime. Germany, a country which saw hyperinflation and fiscal ineptitude create a breeding ground for Nazism, has strenuously and assiduously followed an anti-inflationary path since the 1950s. Along with its position as Europe's largest economy and an industrial powerhouse with excellent economic credentials, it seemed like an ideal model both copy and paste elsewhere and be placed at the heart of EMU.

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[11] As Eichengreen and Wyplosz (2004: 397) illustrate, for example, the fixity of exchange between the European Common Unit (later the euro) with the Italian lira ignited a disinflation process, dramatically forcing down the cost of Italian debt servicing, with a value of roughly 7.5% of GDP, a resulting in a spending splurge. In effect, the 'convergence' process delivered a bounty to Italian consumers while encouraging political support for pro-euro and pro-EU policies as a corollary.

[12] 'Pegging' a currency means aligning one country's currency with another, more credible currency at a fixed rate, usually the US dollar (US$). In Western Europe, applicant member states to EMU pegged their home currencies with the Deutschmark (DM) under the Exchange Rate Mechanism (ERM)

In the pegging EMS regime, the forerunner to formal EMU, the stability of the Deutschmark played a key role for previously frivolous governments to abandon *Keynesianism* (paying for capital spending now with borrowed money) for the more conservative doctrine *Monetarism*, heralding a potential wholesale conversion away from fiscal expansionism based purely on debt i.e. letting public spending spiral while cutting taxes (Sandholtz 1993). This turned out to be a fairytale. A vital and conveniently overlooked aspect to the fixed exchange (pegging) with Germany is a perceived commitment by the markets and lenders which would theoretically see weaker EMS members follow domestic fiscal policies consistent with the Bundesbank. As we now know, the peripheral 'PIIGS' and others completely failed to do this, binging on the 'bubbly gas' of fiscal expansionism (Cohen, 2010).

The cause was straightforward but multifaceted. In EMS and in EMU, the peg itself was enough to convince lenders that weaker economies were being tied into a particular regime; removing a sense of instability and risk, allowing the peripheral nations to piggyback on more financially sound economies, 'importing' credibility. Thus the dual issues of credibility and speculation became controllable bedfellows. If achieving price stability and credibility were, in fact, the sole concern of nations, then membership of EMU makes no economic sense for nations such as Austria, Denmark and the Benelux trio who already boasted low inflation and would have been very disinclined to link their currencies to high inflation countries which would obviously result in imported inflation, making them worse off (Frieden, 2002: 877).

Another problem with the credibility argument is that aversion to Inflation among the public and therefore politically vital low inflation polices[13] were already in place in many EEC nations prior to Maastricht (Collins and Giavaszzi, 1993) suggesting that causation runs from low inflation to exchange rate stability, not the other way around (Thom 1997:13). Along this line of thinking, Germany should logically have never accepted the 2005 relaxation of the rules on the Stability and Growth Pact[14] to make eastern enlargement of the eurozone which was to loosen eurozone entry rules for the new Eastern EU entrants (and avoid getting penalised for Germany's own deficit breech). If credibility was the core concern, then a sharp restriction of the rules and heavier penalties should have occurred which should have seen Germany herself and France lead by example and accept disciplinary action under the excessive deficit procedure (EDP).

There is another opinion where Germany was something of a sacrificial lamb, committing itself to lead a regime where members would 'tie their hands', losing control of their monetary policies, surrendering their ability to wage one facet of economic war known to stir up nationalistic fervour, devaluation. This

[13] In the late 1980s, inflation declined in EMS and non-EMS nations suggesting it was other factors rather than convergence that were responsible (Thom, 1997:13)
[14] Deutsch Bundesbank (2005)

would prove their commitment to a common set of policies (low inflation) and avoid the self reinforcing inflationary pressures caused by uncertainty, all in the good cause of EU institution building for a future strong EMU and European Central Bank (Sandhotz 1993). Of course, as we now know, while the eurozone tied their monetary hand behind their backs, the PIIGS utilised the free hand to exploit this credibility with their debt laden fiscal policy (Eichengreen, 1993: 27).

Thus while some commentators are correct in saying that the rules were lax and the remedies merely 'sticking plasters', they are analysing EMU with a strict adherence to what should happen, rather than take account of what *has* happened. For EMU, German credibility has long been used as a means to an end to create a more inclusive euro and there is no real verifiable evidence to believe that it may arise as the sole consideration for German policymakers in the future.

Economic Argument 3: The real effects of globalisation on trade and investment created the environment for EMU (and continue to make retreat from it unlikely)

Carrying on the logic of OCAs and preferential policy attractions of EMU, there is another argument that EMU was and remains an inevitable (if perhaps premature) regime within the EU. Autonomous pre-eurozone European currency policies were strongly affected by the expected real effects on key variables, mainly trade and investment and with the rapid development of IT in the 1990s and the resulting productivity gains, the catalyst for EMU perhaps requires political foresight rather than pure economic arguments. Politically speaking, the general support for EMU stemmed from a broad church of celebrants, including cross-border investors, multinational businesses, entrepreneurs, financial capitalists and export competing producers of specialised manufacturing goods (and political elites eager to crack the cheap credit goldmine and bolster their standing with their electorate). For simplicity, I will call these the '**EMU trade coalition**.'

This is not particularly surprising considering the evolving relationship between societal actors and the factors that shape national economy policy. Autonomous policy decisions in each EU member state was already significantly constrained by the increasing international integration of markets, long before EMU (Cooper 1968). By the 1970s and 80s, a further break down of the post-war coalition of business and labour interests continued unabashed as business groups retaliated and sought a significant curtailment of state control over the forces of the economy, notably in Mitterrand's France and Thatcher's Britain

(Gourevitch 1988).[15] The death of Keynesianism seemed to raise the possibility of a more restrictive, conservative EU wide approach to fiscal and monetary planning directly in line with the forces of globalisation, competing together against like sized American and Chinese markets, rather than individually, a premise heavily supported by the **EMU trade coalition**.

It is these coalitions of organised interests affected by trade and investment that affects real support for monetary union (and likely to become increasingly powerful based on trends at the time) and not the supposed basis of OCAs and a drive to achieve price stability based on best European (German) practice (Frieden 2002). There is a point in the analysis where the political preferences concerning the economic variables affected by EMU becomes an imperative. In this vein, Feldstein's (2010b) arguments over the necessity for a national autonomous devaluation mechanism to restore the economic health of the 'PIIGS' is short-sighted and represents a typical (and classical) retreat over nationalistic and protectionist fences which might have short run positive effects in restabilising a panicked economy, but only a distracting effect in terms of the overall EZ-17. Historically, as the **EMU trade coalition** points out, devaluations in Europe have a chequered history anyway, with recent examples such as one during the 1992 sterling crisis in Britain having no effect on the decisions of British manufacturing firms moving abroad and creating further distortions. Ultimately these groups view the devaluation mechanism poorly, believing it ultimately raises production costs, lowers output and provoke a wage-price spiral with inflated prices. As Hix (2006: 312) confirms, the long term benefits of floating exchange rates are less than theory assumes, outlining the validity of the principles of comparative advantage and efficiency which require an eradication of all the negativities associated with competitive exchange rates and devaluations.

Admittedly, the current crisis has inevitably eroded support for EMU especially in parts of the EZ-17 which see devaluation as the right medicine to cure their ills. However, the **EMU trade coalition** cannot be assumed to have withdrawn their support like the wider public has. The problem is that currently their voice is crowded out as the politicians seek to thread a tightrope of energised (and angry) electorates to win elections in turbulent times through a 'we're on your side' campaign. This tactic aims to victimise any person, social group or company with even remote connections to the banking or financial sectors, despite their success and responsibility for pre-crisis job creation. Uncertainty, as described earlier, is not caused by anxiety over default per se, but rather over the resulting effects on the larger more influential nations. Uncertainty after all, reflected in exchange rate volatility inevitably affects those with cross border contracts including the **EMU trade coalition.**

[15] The Mitterrand realignment in France in 1983 was an ultimate reflection that the era of demand management and debt fuelled growth was over

The economic logic which states that fixed exchange lessens the uncertainty multinationals face when determining the most effective location for operations, as well as the investors, borrows and capitalists for investing generally, remains valid. The only way to resurrect these damaged economic actors is not to remove the ease at which they were operating previously and seek to overly penalise them. It is exactly this reason why Franco-German politicians are weary to inflict heavy costs on Northern European banks who just so happen to be sovereign bondholder creditors to hugely indebted nations like Ireland and Greece. Doing this would shatter certainty and destroy (and bankrupt) the **EMU trade coalition**, thereby undermining the one reliable supporting group of EMU. This forms a political consensus in Europe since EMU is the mechanism which binds all the trade acts from the Treaty of Rome to the Single European Act, together. In effect therefore, Krugman (2010) is correct in saying that the cost of ending EMU would be hugely disruptive, and Europe is simply stuck with it despite the 'mess.' I would add that this 'mess' is completely undesirable, but in many ways the least worst solution.

Economic Argument 4: Coordination of fiscal policies through adhering to the Maastricht Criteria has succeeded

In recent times, some have become fixated on the escalating GDP to debt ratio or the budget deficits in the EZ-17 to illustrate their view of a rapidly worsening situation and ominous signs of a eurozone breaking rapidly apart at the seems. Even without acknowledging certain flaws in the the euro's institutions, it is accepted that the 'laws' governing euro membership from its inception were poorly policed. These laws, the so called 'Maastricht Criteria' set out in the 1992 Maastricht Treaty and ultimately the German requested 'Stability and Growth Pact (SGP)' were highly imperfect and vague rules, woefully inadequate but politically opportune replacements for more comprehensive economic governance (i.e. a greater say for 'Brussels' in economic planning in nation states). This simply represented 'toe dipping' in the murky waters of economic governance. As a result, members lied their way in (Greece) or were ushered in with a hope of conversion to fiscal rectitude at a later unspecified date (Sarotte 2010).

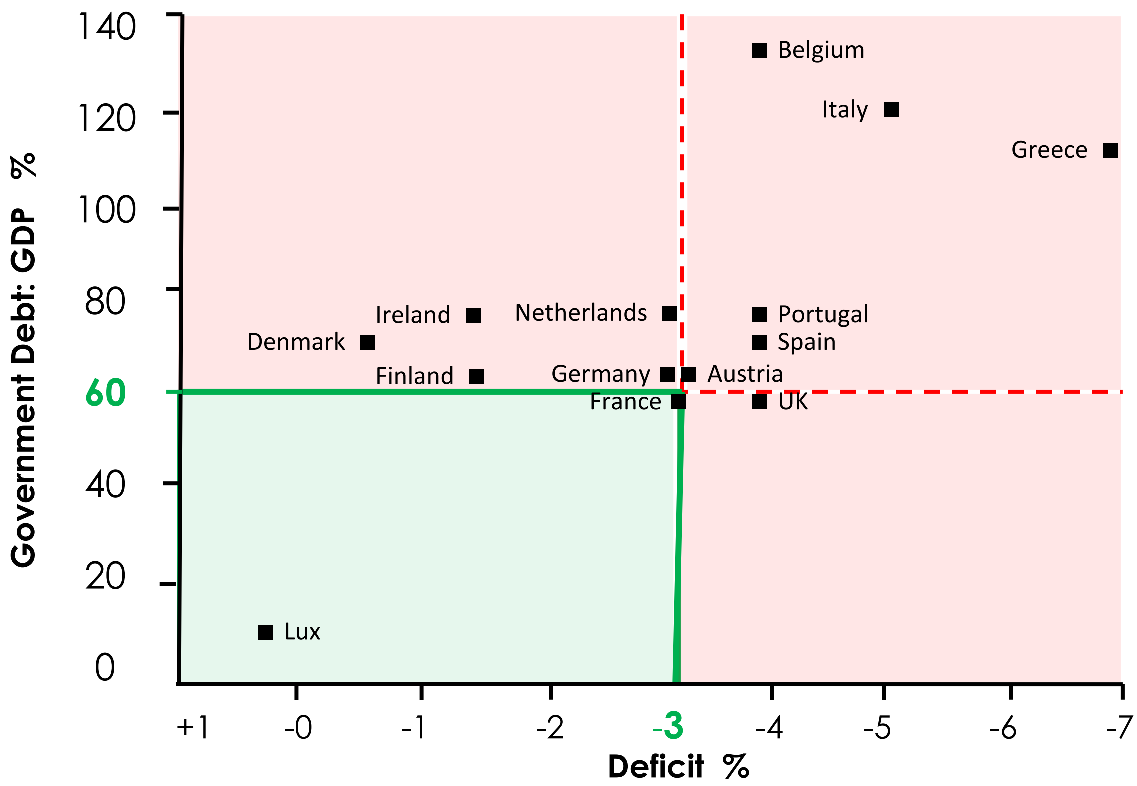
While formally part of EMU, EZ member states guilty of flouting the rules did not incur a straightforward penalty due to ambiguity with the treaty text itself, which merely stated "if there is an economic downturn and output has fallen by more than 2%, then the member state will escape sanction automatically but the deficit should be corrected once the recession has finished"[16] (Arestis and Sawyer 2001). The original elements the SGP dealt with were minor, vague tinkering mechanisms with very weak

[16] However, they conclude that the nature of the business cycle means that the budget position can clearly fluctuate in a stabilising manner, but there *would* be difficulties in dealing with severe recessions. In practice therefore, eurozone governments are fiscally restricted in spending their way out of recession, and 'could be required to raise taxes, cut government spending…..thereby exacerbating the downturn.' (Currie, 1997: 13)

penalties with very weak emphasis on long term planning. The original hopes that the criteria would form a firm foundation for the euro has been proved utterly wrong. Indeed the current crisis has clearly exposed the EZ-17 via the ECB has having no formal process to deal with a national debt crises and certainly no mechanism to deal with the issue of contagion (O'Grady 2010). However it cannot be effectively argued that the expanding deficits and debt-GDP ratios are the beginning of the end for the euro because of one core fact – these 'laws', while they did guide some economies to follow a specific fiscal framework, they were not followed in any serious way. There are a number of key points to mention:

1. As member states had already subordinated their monetary policies to ECB control, their only method of national economic planning was via their fiscal policies – which would, because of the dramatic difference between northern industrial EZ states and southern peripheral EZ states, be necessarily different so the construct of EMU was necessary (and clearly detrimentally loose)
2. Strict adherence to the 1992 Criteria should have produced a much smaller EMU than was ultimately created in 2002

The Maastricht Convergence Criteria: Applicants Compared (1993)[17]

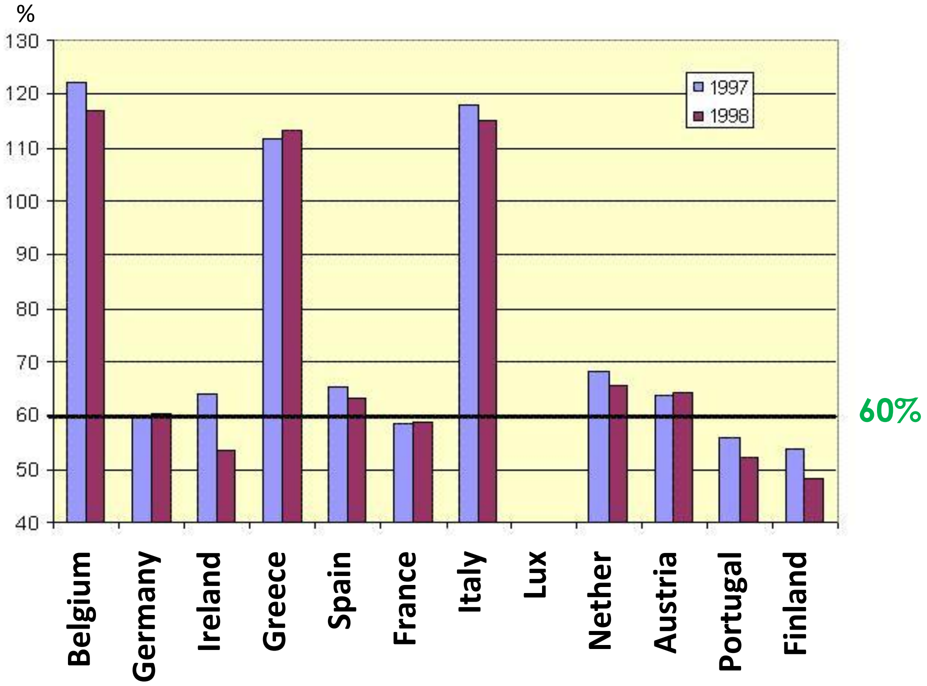


On the first point, it is now abundantly clear that the current problems were compounded from 2005 onward when, In what was viewed by the German Bundesbank as an astonishing act of regulatory malpractice, the SGP was manipulated, becoming a "weaker, more complicated and less transparent fiscal

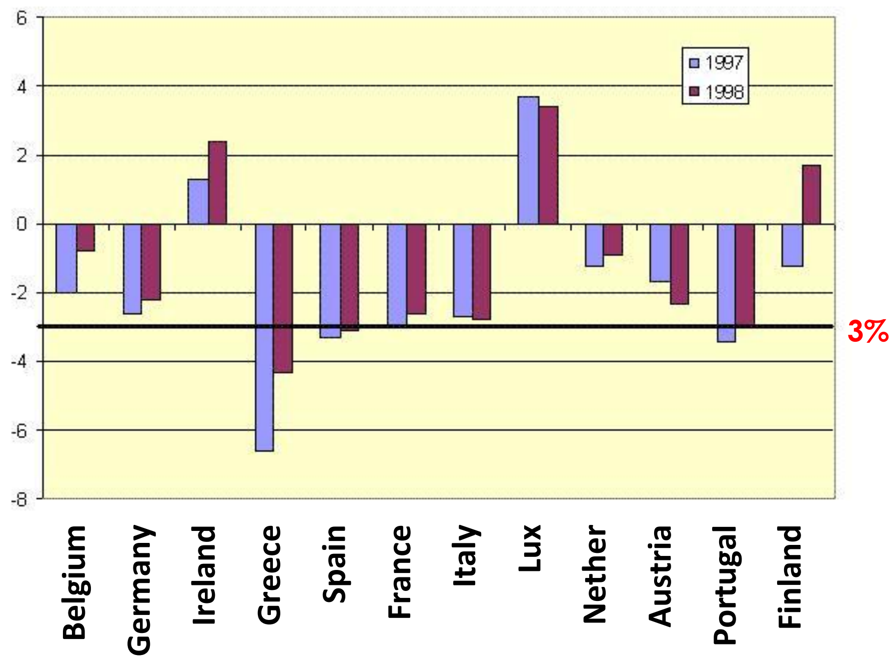
[17] Thom, Rodney (1997)

framework "… in that "…the scope for discretion available to the Commission and the Council will be significantly expanded." (Deutsche Bundesbank 2005:20). Why? Germany and France, politically, needed this as they were actually suffering economically from EMU. This allowed the Portugal, Ireland and Greece to further fuel their debt laden economic booms and allowed Germany and France to avoid penalty for breaching the 3% ceiling themselves (the so-called Excessive Deficit Procedure or EDP). Secondly, a strict interpretation of SGP prerequisites in 1993 and again in 1997-98 would rule out Germany, Greece and Austria from eurozone membership (Thom 1997. De Grauwe 2009). The situation at the in the run up to formal EMU was even more stark, notably in the years after Maastricht. By 1998, the situation for some countries had noticeably improved thanks to a booming world economy but the laxness allowed the entry of unsuitable countries.

Gross Government Debt as a % of GDP (1997-98)



Government Budget Surplus (Deficit) as a % of GDP (1997-98)



Maastricht Criteria allows:

Government Debt: GDP Limit
60%

Current Account Deficit Limit
3%

Change in the Stability and Growth Pact (1992-2005)

Headline Figures

Original 1992 Maastricht Criteria	2005 Reforms
Current Account Deficit Limit: **3%**	Current Account Deficit Limit: **3%**
Government Debt: GDP Limit: **60%**	Government Debt: GDP Limit: **60%**

Preventive Aspects

Deficit Guidelines

Original 1992 Maastricht Criteria

Member States should maintain medium-term budgetary positions that are “close to balance or in surplus”

2005 Reforms

Member States will present their own country-specific ‘medium term objectives’ plan (MTO) taking into account the economic characteristics of each country, in particular the debt-to-GDP ratio and potential growth

Corrective Aspects

Exceptional Circumstances Clause

Original 1992 Maastricht Criteria

- Deficit above 3% of GDP is not ‘excessive’ if it can be shown it is “exceptional and temporary”
- A deficit can be considered exceptional if it results from a “severe economic downturn”

2005 Reforms

Definition of a “severe economic downturn” made less stringent. Now, *any* negative growth rate, or even a period of positive but very low growth compared with the trend, can be considered

‘Other Relevant Factors’ Clause

Other factors taken into account when assessing breach of 3% figure (Excessive Deficit Procedure)

Original 1992 Maastricht Criteria

- “Other relevant factors” not defined but 3 broad categories provided
- No particular specifying what these might be

2005 Reforms

Explicit and long list of 14 “other relevant factors” including:

- Negative growth rates
- Sustainability of debt level
- Public investment
- Pension reform

Penalty Deadline for 3% Breach

Original 1992 Maastricht Criteria

- “Year after its identification, unless there are special circumstances”
- “Special circumstances” were undefined

2005 Reforms

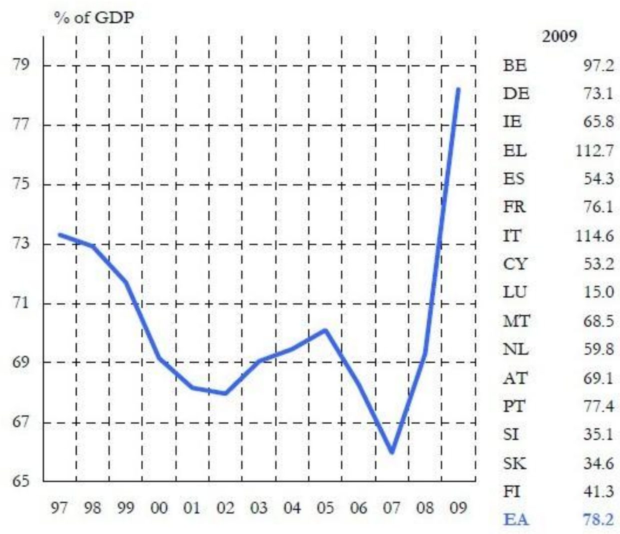
- The 14 factor list of “other relevant factors” serves as the basis for deciding whether special circumstances exist.
- initial deadline for correction set at a minimum fiscal adjustment of 0.5% of GDP pa
- Can be revised if hit by unexpected economic events

Despite this, the requirement of EZ members to run budget surpluses was never properly followed. Further, extrapolating from 1997-98 data, it would be take some 20-30 years for nations such as Holland, Belgium and Italy to reach this perquisite criterion.[18]

Greece is a case in point.[19] Prior to entry into EMU in 2002, Greece was a highly indebted nation and showed no signs of adhering to the criteria notably the 60% debt ceiling. Yet, the prospect of euro accession and resulting bull-market "convergence trades" pushed bond yields in the 'PIIGS' countries toward the level of German bonds, with the ensuing credit boom supporting excessive consumption growth (Roubini, 2010), the consequences of which have become obvious in recent months. Some commentators go so far as to openly accuse the PIGS[20] are guilty of 'cheating' their way into the euro (Warner 2010). Even more tersely, suggests that elements of fraud and 'creative accounting' essentially created economic logic where there wasn't any (De Grauwe 2010).

The situation for 2010 in key nations as summarised below illustrates the aggregate change in eurozone deficit and debt levels in the decade from EMU ascension to the current euro crisis. While the average deterioration is rapid, removing the outlier PIGS from the equation results in a broadly similar picture to the pre-eurozone era.

Current EZ-17 Budget Deficits and Debt Levels in 2009 (as % of GDP)



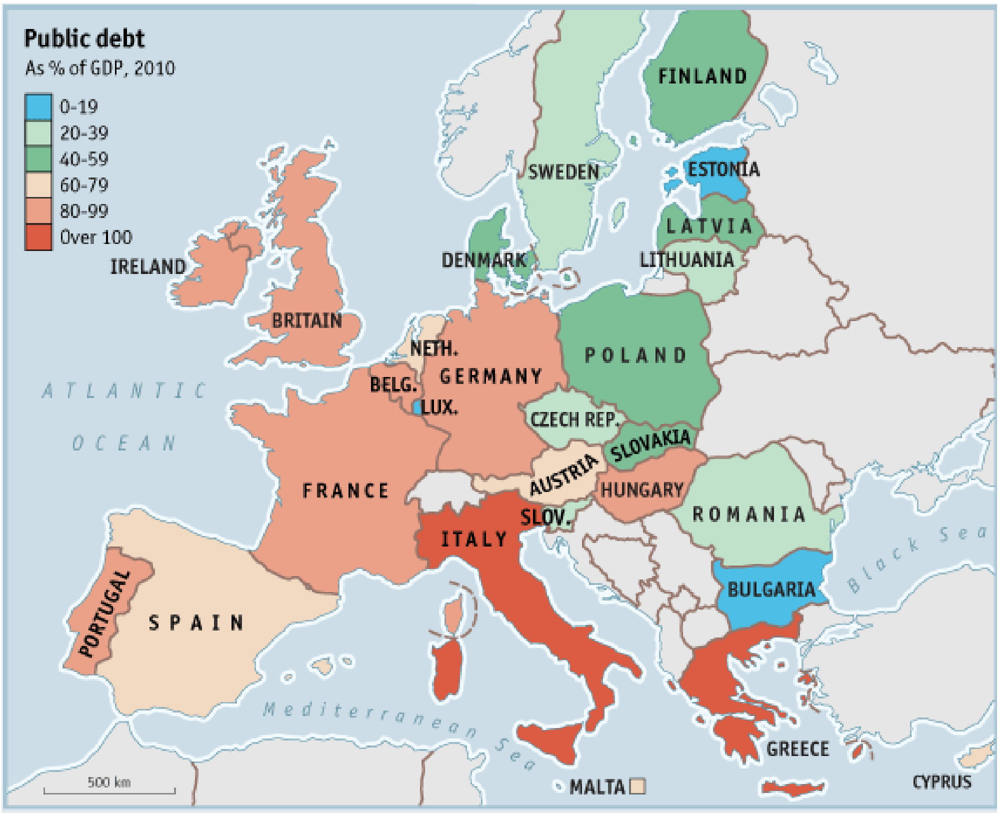
[18] This anomaly coupled with sufficient ambiguity of terminology (such as the 'satisfactory pace' wording relating to debt improvement) created a somewhat lacklustre incentive for nations to truly discipline their respective debt levels
[19] See Chart 1 and Chart 2: Greece=EL
[20] Usually just the 1980s ascension states: Greece, Spain and Portugal.

Maastricht Criteria allows:

Government Debt: GDP Limit
60%
Current Account Deficit Limit
3%

Key variables for selected EZ members (2010)[21]			
	Government General Balance	**Cyclically Adjusted Balance**	**Government Debt**
	% of GDP	**% of GDP**	**% of GDP**
The 'PIGS'			
Portugal	-8.0	-6.6	77.4
Ireland	-12.5	-9.6	65.8
Greece	-12.7	-12.6	112.7
Spain	-11.2	-10.0	54.3
Average	**-11.2**	**-9.7**	**77.55**
France	-8.3	-7.0	76.1
Germany	-3.4	-1.9	73.1
Italy	-5.3	-3.5	114.6
Average	**-5.66**	**-4.13**	**87.9**

The real problem isn't confined to the periphery, especially when it comes to public debt: GDP ratios, as the following graphic illustrates well. This places the 'sovereign debt' crisis into some perspective.



Source: *Economist.com*[22]

Even when consideration is given to current deficits, the situation is no less murky with a slightly clearer delineation between 'core' and PIIGS (excluding Italy).

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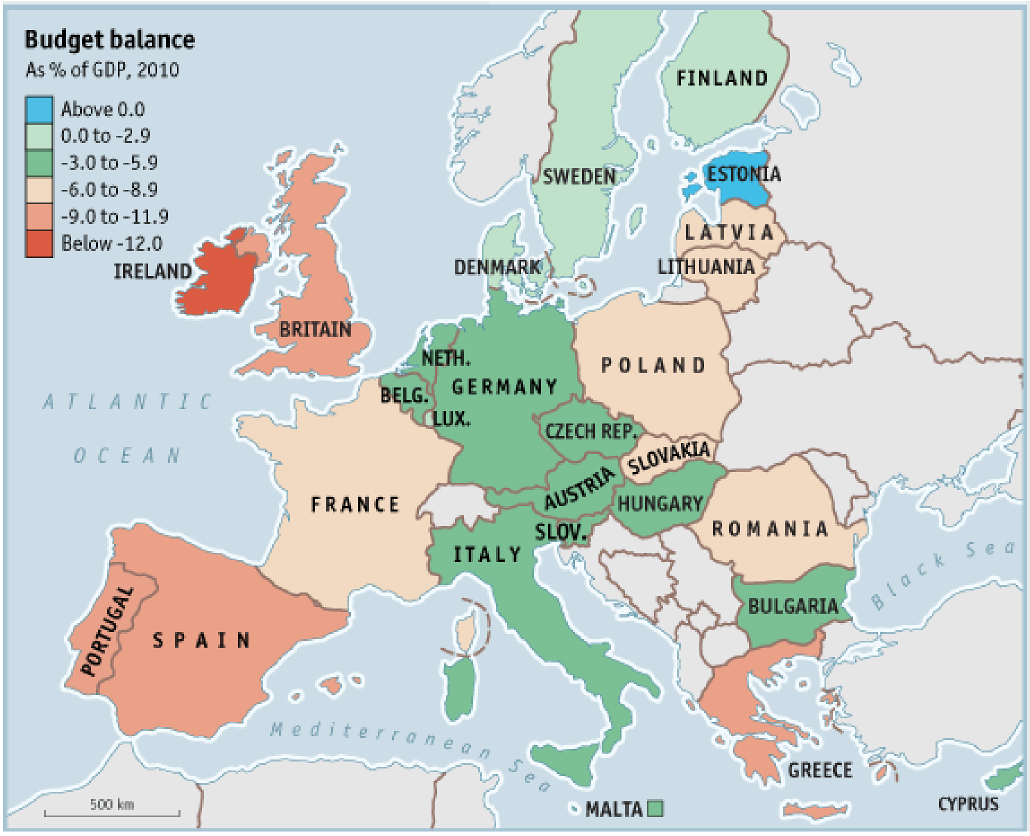
[21] Directorate General DG ECFIN: Economic and Financial Affairs (2010) *Key Indicators for the Euro Area*. 14 January, 2010. http://ec.europa.eu/economy_finance/db_indicators/key_indicators/documents/key_indicators_en.pdf

[22] Charts sourced from http://www.economist.com/blogs/dailychart/2011/05/europes_economies



Source: *Economist.com*

Plans for the formation of the eurozone proceeded despite the abundance of outliers from the seemingly uniform Maastricht Criteria. it would seem anomalous to suggest their existence today is suddenly a great shock to the eurozone as a whole.

Economic Arguments: Conclusion

Those suggesting the euro is doomed are assuming the eurozone is a fundamentally economic animal, using four main economic arguments which have been shown to be inexact at best. The eurozone has always had a flawed pedigree. For EMU, economics doesn't comprehensively explain causality so it cannot comprehensively explain (or promote) continuity. For example, if an expanding eurozone is becoming less and less like an OCA then there must therefore be more diffuse causality behind the project which is perhaps not as empirical. This would provide more credence to the commentators would believe the euro, while flawed, is sustainable into the future. There must be another (political) 'invisible' hand at play. As shown, the 'real' effects represent a bridge between the economic and political theories and represent the compromised reality from which EMU operates. Dissecting the economic theory, solely, the verdict on the economic sustainability of the euro is **inconclusive.** The affects of the current economic situation on the single currency are therefore, by corollary, not exhaustively laid bare by the economic logic alone. The analysis must now, therefore, turn to the political sustainability of EMU.

The Political Arguments behind EMU

'It has often been argued that the conditions under which monetary integration might reasonably be expected to succeed are very restrictive. In fact, these conditions appear no more restrictive than the conditions for the establishment of a successful common market. The major, and perhaps only, real conditions for the institution of either is the ***political will*** *to integrate on the part of perspective members.'*

- Norman Mintz (1970: 33)

While the economic logic underpinning EMU is weak, its establishment whipped member states into fiscal shape, at least theoretically. The benefits of this were farsighted and attractive; improved credibility (often via the recognised 'EZ norm' of central bank independence), improved ease of attracting international capital and a level of certainty ensured by stabilised exchange rates. However this still does not properly answer the question as to why EMU came about in the first place. For this, we must turn to the political logic of EMU which is not viewed by many as obvious (Sandhotz 1993:11). The political perspective however is more revealing and less ambiguous than the economics.

'…the creation of the EMU is far more than jut the outcome of economic considerations, just as the evolution of the EU itself must be regarded primarily as a political development.'

- Helmut Schlesinger (1996)

Why would any sovereign state choose to voluntarily surrender their often hard fought right to control their own sovereign financial affairs, specifically in relation to setting interest rates and currency valuations - by opting into a monetary policy under German stewardship in Frankfurt? Cohen (2003) lists two characteristics from a political perspective as crucial for the fate of monetary unions in political economy theory, which represent two key pillars explaining the reasons behind state membership of EMU.

(1) **The Realist Reason**: The attractiveness of joining a system anchored by a strong, stable and above all creditable German 'controller' state
(2) **The Institutional Reason:** EMU is merely an extension of the European project and builds on the strong sense of 'community' among European states

Political Argument 1: EMU is an attractive system as it is anchored by a politically strong controller state – Germany

TRUE

When children who have long left their family homes find themselves in a desperate situation, they will inevitably fall back on their parents, however acrimonious their relationship was before parting ways. For EMU, the parent is Germany and the children are pretty much everyone else (with France as the usually loyal spouse). In a sovereign sense, German control of EMU and quasi-control of the non-political ECB (by design) creates a position where Germany is the de-facto hegemonic anchor state and 'lender of last resort' for the entire EZ-17. The reasoning is straightforward. Prior to Maastricht (and since) Germany boasted large trade surpluses (especially with eurozone partners), competitive labour costs, controlled domestic spending and an historical fixation with price stability. A member of any regime with Germany at its epicentre effectively free rides on German credibility and achieves more under that protected monetary security umbrella than they would as an isolated, small, vulnerable economy in an increasingly globalised and competitive marketplace. Politically, Germany is one of the great success stories of European diplomacy with West German fingerprints all over the European project from the outset.

Of course, there is a downside. Some EMU members weaselled their way into such a regime, enjoy the spoils, binge on borrowed public expenditure and big capital projects, panic unceremoniously when things turn ugly and turned to German political leadership, which ultimately controls the European purse strings, to bail them out. This, in many ways, remains the prolonged German 'war guilt' sentence for the atrocities of WW2. These members are hardly likely to remove their German crutch now that they teeter on the edge of the economic abyss. For credibility reasons and to maintain some vestiges of an independent financial future, the Greeks or others, for example, should not want to send the signal that they are the weakest link in the eurozone. Inflicting this damage on the entire EMU system would merely drag everyone down with you. As bad as things are now regarding peripheral competitiveness lag, the withdrawal of a nation or break up of the eurozone generally would lead, put simply, to the 'mother of all financial crises' not least because of the damage it would do to German credibility (Eichengreen 2007). Those countries suffering from diminished credibility and teetering on default are hardly likely to ditch the most credible card in their rapidly depleting deck, that of independent ECB control of their monetary policy with German political leadership backed up by German economic might and importantly, German cash. German political stability and post-war German politics breeds stability- which the markets like.

Then why are EZ countries heavily criticising Germany? The only other option therefore is to fix the mess you are responsible for yourself through a 'fiscal devaluation', also called forced fiscal deflation of painful austerity measures, higher taxes and drastic privatisation to fix the current balance and reduce the crippling national debt. Why would any of the EZ-17, the PIIGS and notably the Greeks choose such an option? A lot of it is economics. In exchange for EU-IMF aid, they have no choice. However there is a reason for this. The only other way to avoid this painful austerity is to devalue your currency – making your exports cheaper and thus growing your way out of recession through trade surpluses. One Inconvenient truth is however that EMU membership represents a monetary 'straightjacket' which makes financial and structural reform far more difficult (Roubini, 2010). Under EMU, the option of monetary devaluation is removed leaving only the fiscal hard medicine suggested by the Franco-German alliance. The question is whether this is politically feasible. For Germany as the nurse it most certainty is, whereas for Greece, as victim/patient it isn't. The recent Greek riots, political brinkmanship and national strikes illustrate the problems that the peripheral states face as a result, regardless of austerity programs. History suggests that this approach requires a stringent line from the Franco- German to maintain the credibility of the entire system. However, the political subordination to German leadership by the EZ-17 adheres to a core economic belief that devaluation is now an ineffective and destructive tool even were Greece, Portugal or Ireland to withdraw from the eurozone. It would ultimately be substantially offset by the eventual demand by native workers for higher nominal wages and wrecked by industrial unrest, not even to mention the monetary costs of converting current euro debt into the new currency. Other solutions such as the watered down suggestion of a 'eurozone holiday 'for the PIIGS where members can opt out, for now, and opt in afterward, has been decried as illogical, and perhaps even dangerous for the same reason (Baldwin and Wyplosz, 2010).

The inescapable reality is that the sole remaining certainty in EMU is the German role itself, the lynchpin to both the euro and the wider EU. Integral in some respects is the fact that German banks are exposed to the PIGS to the tune of over €370bn, a fundamental indication that Germany isn't fleeing over the horizon in the near future. They are indebted to the success of EMU. (Coy, 2010). As Cohen (2000:9) states 'sovereign governments require incentives to stick to bargains that turn out to be inconvenient,' which is certainly true in the Greek case where German efforts to maintain the hard line have been met with extreme derogation.[23] Ironically, the worse the situation appears to get, the more a credible path is forged on the complexion of a future EMU becomes as if Germany is 'expected' to bail out the profligate states, then this will mean a louder German voice in EZ-17 national fiscal policies and probable stronger, evolved EMU institutions. Effectively, the crisis will only mean a greater role for German technocrats, one way or the other, and this can only be a stabilising factor. The markets realise this, as do German policymakers who can demand conditionality due to the fact that banks, under similar stress, were required to forfeit a large portion of control.

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[23] See **Appendix 2**

Of course, there is a potential challenge to this and this is primarily political. There is no historical precedent among democracies for the creation of any central redistributive authority (as some suggest should be installed now to prevent future crises by forcing countries to harmonise in key areas), German or otherwise, in the absence of national parties operating in the national political institutions in a relatively disciplined manner, a fact which has been made abundantly clear in the Greek case (McKay 1999). Ultimately, all eurozone members are EU members with long historical economic and political ties with long held memories of the catastrophic effects of the combative political events and economic policies of the 20th century. However, EU level politics lag severely behind economics which has caused untold damage to the entire EZ-17, but especially the PIIGS, as the dominos effect of contagious sovereign and banking debt fears spread, bond yield spreads deteriorate and Spanish and Italian credibility is questioned (Garrett 1998: 787). It is often forgotten that EMU was only considered the first step in a more extensive process of collective institution-building at the European level and the character of collective bargaining within its member states (Hall and Franzese, 1997). In the absence of a European wide identity and a party system nationalistic tendencies and insular interests respectively will come to the fore without mechanisms to solve crises. While politicians engage in national elections 'offering chimerical programs and slogans', European parties rarely have a cohesive platform while the pace of financial movements and speculation continues at a 'furious' pace.

The eurozone, like the EU, remains a 'peripheralised union' (Riker 1999) lacking a central strong core. However to correct the imbalances, it is feasible to see welfare provision from a central authority as a mechanism to allow states exploit the European institutions for the benefits of diverse regions and political cultures without a competitive element. This is why the current crisis had reignited a debate over the future economic governance of the eurozone, a very predictable result according to this political argument.

Political Argument 2: EMU represents a further extension of the European project and its sense of community with members heavily invested in its success

TRUE

Where the euro falls down is ironically not at its weakest point. It is only through the economic crisis that we have seen proposals (most not radical or even new) to reform the economic institutions of EMU, which requires political consensus – something difficult even in a period of euro-optimism! The correction measures entail severe political consequences for member states (Irvin 2010) but then so did the original subordination of monetary policy in the 1990s. As shown, what is now in question is fiscal policy – the one remaining vestige of financial sovereign independence in the EZ-17. By and large, the political structure of the EU and the EZ-17 in EMU remains, as of now, untouched.

To explain this out, let me use a comparison with the US dollar. The euro is criticized, with some justification, for being a weak willed and poor replica of its mighty American cousin (Cohen 2010).With regard to the aspirations for enhanced political alignment, the results broadly indicate failure as nationalistic tendencies remain dominant, never clearer than in Athens, Lisbon, Madrid and Dublin as parliamentarians (predominately in opposition rather than in government) openly 'side with the citizens' and vent their frustration by saying 'screw you' to Europe. As of yet, this crisis has been about emergency solutions to stem immediate difficulties while doing the clichéd 'kicking the can down the road'. This is for a very simple reason. Thanks to the political horse trading of the first US Treasury Secretary Alexander Hamilton and his astute maverick move against the concerns of American founders such as James Madison and Thomas Jefferson[24], the financial coherence of the United States was laid at an early stage of American industrialisation with the establishment of the US Mint in 1792. American industry therefore evolved with a strong basis on financial coherence upon which a stable financial apparatus has since developed. Thanks to sheer political will and power of the still weak US executive office centuries ago, the American states were eventually absorbed one by one and cohesively into an enormous (in scale and eventually in value) economy where the majority of tax and public expenditure is collected and administered at the federal level (Cohen, 2010). Even built on this strong foundation, it took decades for the citizenry in all regions to accept national parties and a collective macro economic policy (McKay 1999).

What about Europe? Fractious European history which doesn't bode well for future collaboration. However, this same argument was used in 1945 prior to the formation of the European Coal and Steel Community (ECSC) in the early 1950s – a far cy from 1792. Ultimately, the issue is not exclusively economic, it's geopolitical. At a time of 'belt tightening' across Europe, the notion that historically austere, pragmatic German taxpayers rescue the profligate Greeks creates anger on both sides: anger by Germans at having to finance the fiscally irresponsible versus resentment by Greeks of the resulting subjugation under austerity measures Germany would impose (Warner, 2010). The resulting friction would deal a hefty blow to European co-operation with the political contagion of growing distrust among the European members a far greater concern than simple economics. However it is these economics which brings the urgency needed to compel political action based on the current strong unified basis in the EU and EZ-17. Recall that there is precedent in this. The Americans learned quickly the price of stubbornly sticking to the politically popular route in 2008 at the time of the Lehman Brothers collapse when New York Fed Chairman Timothy Geithner declared, "There is no political will for a federal bailout." (Johnson and Kwak,

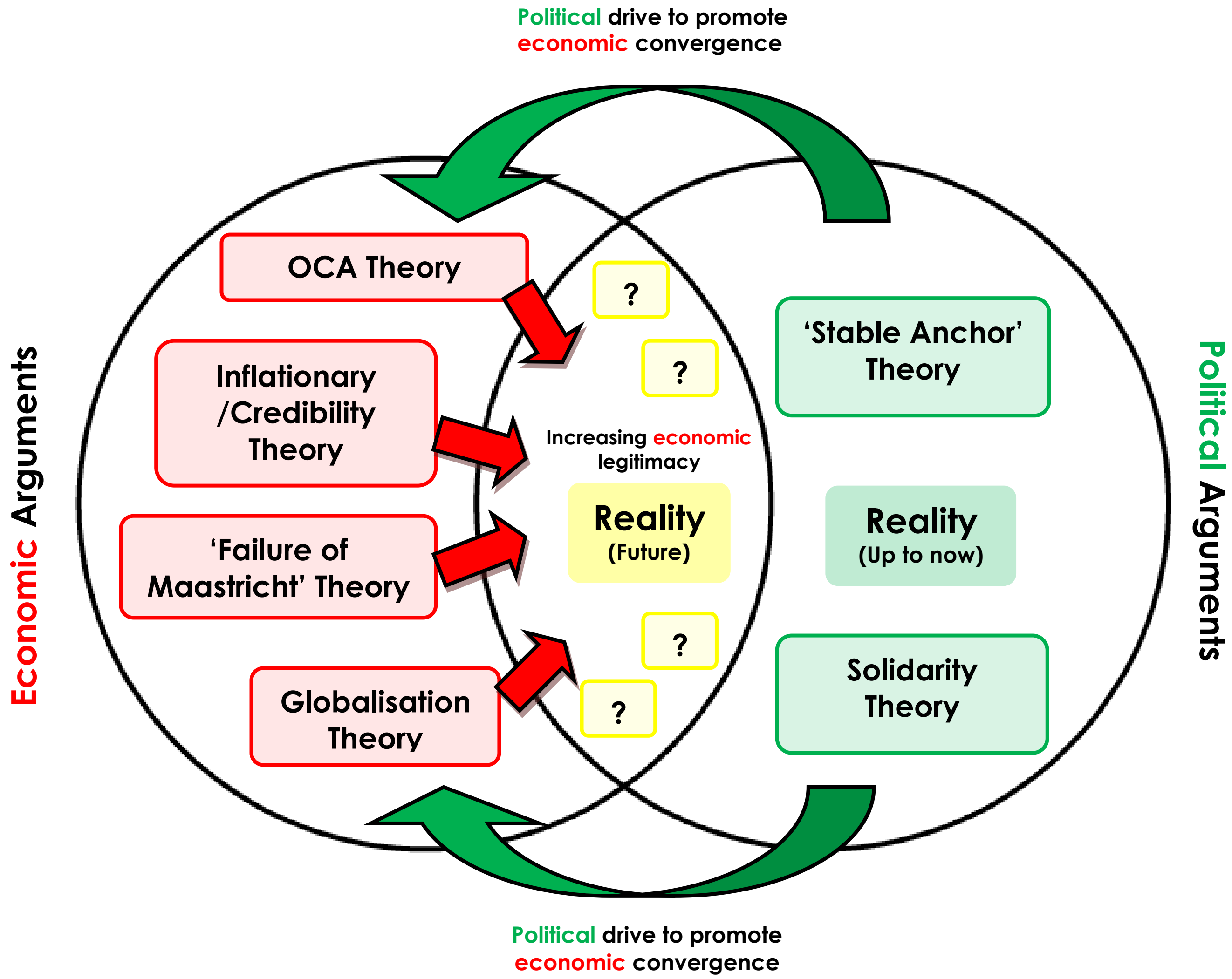
[24] Hamilton was a member of the Federalists whereas both Thomas Jefferson and James Madison would become US Presidents on the Democratic-Republican ticket.

2009). $700bn would arrive for that very purpose when the US Treasury had only its federal (and inherently political) might to stave off collapse of the entire US financial system and save Wall Street. There was never a question of state default because that is not in the vocabulary of US policymakers.

For Europe, it's a story of endless catch up. European governments and voters still have incentives to play the blame game against the EU – a 'Brussels Vs. Us' mentality which, considering antipathy US citizens feel toward Washington D.C., is not necessarily a big problem. The US utilised political unity to evolve and change social attitudes into accepting more economic unity and federal macroeconomic policies. The EU is trying to do the complete opposite, utilise economic unity to evolve, however limited, into accepting federal coordination policies, feasible only through enhanced political unity. EMU is therefore the vehicle, rather than the final destination. This challenge is further complicated by domestic factors in EU member states such as a European wide aversion to 'external' despotic rule, intense nationalism and a strong sovereign desire to control ones own affairs – factors which mirror perfectly the original fears of US states (hence the Revolutionary War and ultimately, the Civil War). Expanding this EU-US analogy further, is it possible that the current EMU/EU structure, effectively an EU confederacy, is built on a set of frozen ideals (such as the debt-deficit Maastricht criteria fixation) which no longer serve (Galbraith, 2011). It is not more credible therefore to suggest that Europe *needs* this crisis to get their political asses in gear? Sometimes from great crises come great opportunities and Europe has shown this to be exactly the case.

Like the Southern Confederate US states, clearly the PIIGS have economically failed (at least in some ways) and sufficient measures need to be taken to restore their fiscal health. Europe can either paper over the cracks with stopgap solutions and await a belated Rooseveltian 'New Deal' programme amid decades of austerity suffered by lost generations (the US waited 70 years) or it can bite the bullet and use the economic panic to stir an institutional revolution, correcting the problems of EMU (Galbraith, 2011). Ultimately, euro-solidarity has come from crisis and if this crisis is as grave as we're being told, then it should represent a pivot point. A new dawn for euro-politics will then mean fresh thinking on euro-economics. The only realistic scenario out of the current PIIGS quagmire is this 'new economics of mutual support.' The alternative is panic, messy defaults, dissolution of the eurozone, rapid inflation, collapse of exports for a much smaller 'nucleus' eurozone and rapid depopulation of the EU periphery (Galbraith, 2011). As Bin Smaghi (2011) asserts, "Europe's union has no modern precedent. It demands original thinking, as much as, if not more than, that of the United States' Founding Fathers. It also requires similar political courage and leadership."

The Economic and Political Theories behind European Monetary Integration[25]



[25] Cohen (2010), DeGrauwe (2010) and McKay (1999)

Apolitical Solutions

There is every reason to believe that the EMU will overcome the current challenges. However we are posed with an important question. In order to bridge the trade off between strong German control and a community approach, is the EU-IMF solution a cop-out or an admission of the delicate nature[26] of the eurozone? Again, it is a contentious and highly debated issue. Bailouts and financial assistance packages require unanimity in the European Council, which always means Prime Ministers, Chancellors, Taoisigh etc report back to national parliaments in a fractious belated process. Any member can block any decision, with the necessity for unanimity making timely decision-making impossible (Bin Smaghi 2011).

Some believe that regardless of belated Franco-German assistance, the situation requires a more global approach akin to that formerly of the Bretton Woods system, whereby the IMF intervenes for the good of global commerce and to establish lost credibility (Fleming and Shipman 2010. Matthes 2010. Roubini 2010). This is perhaps an admission of reality. The fact that EU-IMF conditionality on policy targets can produce the incentive for painful structural changes is reflective of the tenuous political relationship between the eurozone powers, as well as the problem of a monetary union predating a political union. Peripheral eurozone members, who have small voices in the ECB and are victims of a further democratic deficit in key EU institutions, are likely to easily retreat to national policies when it suits. This view is correct insofar as economic expediency matters when it comes to the avoidance of insolvency and sovereign debt default but the need in the eurozone is of a *political* nature and thus there is a certain belief that it should sorts its own problems. Only a comprehensive strategy, backed up by political unanimity, can save the eurozone. (Roubini 2011)[27]

There are three basic stated solutions to the current crisis. Collective 'Eurobonds', a European finance ministry and a pan-European banking solution.

a) Eurobonds

Once we started talking about Italy, our chickens came home to roost. It is now virtually impossible to avoid the economic juggernaut hurtling down the tracks at us. European politicians are behaving like cartoon characters holding tiny umbrellas while a 100 tonne weight falls from the sky. Except in Italy's case, it's a €335bn weight, stuffed with government debt. If it the private market (bond market) rates rise

[26] Or, of course, realisation of the politically neutered nature of the eurozone
[27] Roubini, Nouriel (2011). 'The Eurozones Last Stand.' Project-Syndicate.org 18 July, 2011.

to an unsustainable level, then Europe will be in an impossible situation where it cannot stop an Italian default. However to reassert credibility in the markets is not to prolong stopgap solutions such as the European Financial Stability Fund (EFSF) or any similar solutions. Even with €440bn now available, it is woefully inadequate because it doesn't change the fundamental problem of a lack of fiscal coordination in EMU. Europe cannot be in a very strange position where the debt of a country's banks is 'safer' than the sovereign debt. The question arises about whether the sovereign debt PIIGS crises in the periphery are problematic *only* through the lens of threatening the viability and liquidity of Northern European banks. If that's the case then are the priorities mixed up? Are finance ministers in the EZ-17 hoping that relieving the banking sector will fix the flow of credit which feeds into economic growth and therefore a return to fiscal health? This seems a slight denial of the rapidity of the events. Markets are instant. European political actions are (and have proven to be) glacial.

One means to allay the panic is for the eurozone to issue debt as joint bonds – with the EU-17 combined issuing debt at far lower interest rates due to the collective prudence and creditworthiness of larger EZ members, with Austria, Finland, France, Germany, Luxembourg and the Netherlands boasting AAA sovereign credit ratings. These bonds would be far more attractive to investors and avoid the disastrous contagion effects and avoid imposing panic inducing haircuts on Northern European bank creditors. They would also be manageable to the nations in trouble and credible to the markets at large (Stiglitz 2011). Guillotining sovereign debt like this will ultimately cause domestic banks in the periphery to fail anyway, deepening the crisis and making it less likely a country can avoid default. However, make no mistake **Eurobonds** = **EZ-17 fiscal integration** + **an end to unchecked national fiscal spending.** Eurobonds require a federal system of taxation and revenue transfers which is currently politically untenable in member states and notably Germany which insists that such a move would require a revision of the EU treaty and stir up further political wrangling and foot dragging and achieve little in return.

b) A European Finance Ministry

The ability of members of the eurozone to manipulate their fiscal policies for competitive advantage or to fund political opportunism has been the greatest failing of EMU. It is now apparent that political decisions in one country directly affect the economies of others, despite what their overall contribution to EZ-17 GDP (Bin Smaghi 2011). Trying to manipulate this reality and present the failings in the PIIGS as 'isolated' distorts the overall macroeconomic reality. The current crisis has revealed a plethora of failings, amplified by increasingly erratic responses by EZ finance minsters to what is, in fairness, an asymmetric shock in the periphery. What Europe badly needs is a clear, organised, sustained and credible mechanism (Cavallo and Cottani 2010. Baldwin and Wyplosz 2010). Europe lacks a federal budget and financial institutions to redistribute income and absorb economic shocks. The current 'beggar thy neighbour' approach means competitive political tension between members each and every time EU budgets are drafted or EU/EZ crises rear their heads with unnecessary politicking.

To force painful fiscal discipline in the profligate states, as well as perhaps encourage a long term political commitment by eurozone members to never allow the situation to arise in the future may encourage the political will to create stronger, more powerful federal eurozone-wide institutions, at least in the 'core' eurozone members. As some suggest the ECB badly needs an appropriately financed and apolitical central treasury and more mobile labour markets to correct the wide structural variances currently exposed for all to see (Warner 2010, Cohen 2010). This idea was first mooted with the 1977 MacDougall Report. The 'austere' Maastricht conditions, currently very loosely policed, will likely and belatedly result in this in order to allow the homogenising project to continue unhindered (Eichengreen and Von Hagan, 1996). Difficulties with passage of even the procedural Lisbon Treaty in Ireland, one of more pro-European states, illustrates the enormous gap between political achievability and economic expedience regardless of the need for sustainability in the eurozone.

A key example is McKay's (2005) assertion that fiscal discipline should be reserved for member state policy level and not the federal level due to the necessary conditions for political sustainability, in direct conflict with the economist's prescription. Moving toward the kind of fiscal and labour market integration the eurozone truly requires (Krugman, 2010), while so integral to avoiding future exogenous shocks, is an ominous task and perhaps the crisis provides the catalyst, politically, for this to belatedly occur. The issue of fiscal rectitude is therefore an inherently political issue. Tackling a debt laden fiscal policy by dramatically reducing public spending tends to result in industrial unrest and a rise in governmental instability. Similarly, efforts to raise taxes by either broadening the tax base or by taxing higher earners create disincentives for work and investment in an environment where unemployment and capital flight is already the cause of serious strains on the public finances. Nations with previously loose budgets who reduced taxation to fuel economic growth in the good times are left with painful decisions.[28]

This reality was reiterated recently by ECB head Trichet, saying "The governments need to speak with one voice on such complex and sensitive issues as the crisis."[29] Greek Prime Minister George Papandreou, condemned the "indecisiveness and errors" of the European response to the crisis, outlining his view that there were "a cacophony of voices and views" and its effect was "creating more panic than security."[30]

[28] The 'PIGS', notably Greece, Spain and Ireland have the lowest tax burdens as a percentage of GDP in the eurozone, of 30.5%, 30.6%, and 27.5% respectively. Conversely, France, Germany and Italy have comparable figures of 40.3%, 39.9% and 42.5% respectively. (DG –ECFIN)

[29] http://www.rte.ie/news/2011/0718/euro-business.html

[30] http://www.economist.com/node/18958569?story_id=18958569

c) Pan-European Banking Solution

European banking remains staunchly nationalistic, never more evident than in the Irish case. This means that reinforcing the highly interconnected network is the job of national regulators, with guidance from the stress tests at EU level. As many commentators have asserted, the best or only way to stop contagion is to implement a prudent pan-European plan to recapitalise EZ -17 banks. This, as a logical extension to the current support from the ECB, would at least fix one deeply cracked pillar supporting EMU. Without credit flowing, theres no growth. Without growth, there's no pathway from austerity. Without a path, despair, political instability and a massive flight of investor capital is inevitable – likely to the resurgent BRICs – Brazil, Russia, India, China (and maybe South Africa). With this on the horizon, there's no investment now for profit later. Investors flee and the economy, on the whole, becomes dilapidated and less competitive than ever. It can never return to the lofty heights it once enjoyed in the golden days of EMU. One facet of the economy, banking, needs fixing before anything else can realistically be achieved.

One such solution is the idea of the European Monetary Fund (EMF) as endorsed by some Germans, including Finance Minister Wolfgang Schaeuble (Sarotte 2010) which would loan funds to nations in explicit emergency situations to capitalise their banks in a non-political IMF style way. Critics will accuse authorities of political interference just as the IMF is accused of being an adjunct of the US Treasury (which it effectively is). Then again there are other solutions. Others include the creation of a European credit ratings agency to combat the perception that American agencies are misunderstanding and misrepresenting the European situation.[31] Then theres the idea of a European 'Marshall Fund' or some sort of Solidarity Fund for Stabilisation which as Stiglitz suggests could team up with the European Investment Bank to finance capital projects in the EZ-17. Then we have the proposal to expand the EFSF (the €440bn EZ fund backed by an AAA credit rating) to finance the buying back of bonds, which in the Greek case means tackling a €340bn mountain of sovereign debt and cutting the debt-GDP ratio below 80% from a staggering 160% projected in 2011 (Baker and Taylor 2011).[32] Some have suggested even taxing the banks rather than shearing down amounts owed to creditors, which would avoid the pain in an indirect way (Sachs 2011). If debts are somehow guaranteed (and creditors are reassured they wont be burned) then investors will return but this requires macroeconomic coaxing. Some suggest cutting the interest rates on the EU-IMF bailout packages so the periphery can begin to chip more in themselves to the process.

[31] http://www.independent.ie/business/european/merkel-calls-for-european-rating-agency-2824244.html
[32] Baker, Luke and Taylor, Paul (2011). '*No Consensus as Europe limps Toward Greece Summit.'* Reuters. 18 July 2011

However the window for decision is narrow. As Professor Paul DeGrauwe said recently "We've had solutions in the past, but we haven't grasped them," he said. "Now it's too late for some of those solutions to work anymore; the opportunity has been lost." (Baker and Taylor 2011).[33]

[33] Baker, Luke and Taylor, Paul (2011). '*No Consensus as Europe limps Toward Greece Summit.'* Reuters. 18 July 2011

The Cataclysmic Mess in Nutshell: EMU, PIG and History Lessons from Keynes

"Greece, like other countries, has to experience that if one doesn't stick to fundamental rules of stability one has to pay a high price, which Greece can't be spared from."

- German Finance Minister Wolfgang Schaeuble[34]

If the pages before this seem a bit heavy, heres a brief overview of where the EU stands right now. The recent crisis has revealed in very agonising fashion the endemic failings of EMU from a policy 'one size fits all' perspective. The usage of EMU by peripheral EU members to 'leapfrog' on the back of credible, creditworthy financially strong nations has led directly to the restructuring-default impasse of 2011. The consistent view of the financial markets is not default per se, but the risk of contagion from and between the so-called PIIGS and its effect on the larger more stable nations and, inevitability, on the European lender of last resort and anchor of the euro, Germany. Aside from the rhetoric, fiscally speaking, just as a budget crisis in New Jersey or California cannot pull apart the US dollar, one in the PIIGS cannot, by itself, bring down the euro[35]. Inevitably, Historical factors and path dependency play key roles.

The real problem stems from, as Krugman (2010) correctly asserts, if the situation among the PIIGS is not uniformly the consequence of a sustained period of fiscal irresponsibility like some assert, than how can EU-European Commission-IMF (troika) force common austerity plans upon structurally and fundamentally different economies? For example, previous economic mismanagement and governmental profligacy is far more prevalent in the Greek case than the Irish case, which is predominately a fiscal crisis caused by a severe banking crisis. Does that mean preferential treatment is likely for Ireland? If not, why not?

The problem now is how, without the correction mechanism of devaluation to reinstate a competitive edge for exports do Portugal, Ireland and Greece return to economic health especially in the midst of painful deflationary austerity plans and, in the Greek case, future massive privatisation schemes and public sector wage slashing. As Krugman asserts, we are in a quite bizarre situation, akin to the Hoover Administration in 1930s Great Depression America, where authorities sought to deflate a balloon economy which had already unceremoniously burst. This so-called 'inverse Keynesian compact' took the opposing view of Keynesian stimulus spending (to jump start economic engines by pumping in cash, like 'oil', to get the economic 'engines' working again) by aiming to tackle crises by doing all you can fiscally to restore confidence. In a panic, all you can really do with any assurance is combat collapsing recessionary

[34] Schaeuble, Wolfgang in Anonymous (2010)
[35] Irvin (2010)

tax revenues with deep cuts to public spending to meet avoid drowning in red ink. Of course, the question then arises – if the Hoover method prolonged the Great Depression, why are the troika insisting on this in the Irish, Greek and Portuguese cases?

The most obvious answer to this is simply, the lack of an alternative. Adopting the Keynesian approach of fiscal stimuli, or some variant of a 21st Century Marshall Plan (as tentatively accepted in the July EU Council Summit) requires a total recalibration and reappraisal of monetary policy within EMU to possible incorporate the creation of Eurobonds, the creation of a European Treasury Ministry through the beefing up of the ECB or a pan European bank rescue plan. Politically, this is difficult because, ironically, the ECB is a-political and therefore semi-detached from the meddling influence of the EZ-17 and EU-27. It is perhaps also true that it is the response of the Franco-German alliance to the Greek situation that has the markets gittery. The game of German-PIG brinkmanship over aid packages, sharp political disagreements in Ireland and Greece over their EU-IMF deals and recent Franco-German disputes over the role of the IMF has contributed to a deepening global realisation of a farcical situation – there remains a continuous absence of *economic governance* in Europe (Fouquet, 2010). Essentially, no one wants to make the tough decisions and we arrive at the clichéd term of 'kicking the can down the road.'

The 'inevitability' of eurozone bail-outs and yet the weakness of detail over the European Stability Mechanism (ESM), the post-2013 successor to the €440bn EFSF eurozone fund, has shaken financial markets by injecting uncertainty into an already festering wound. Were a common, comprehensive and most importantly financially enormous solution to be found, weaker nations would be able to lower their astronomical borrowing costs, tap emergency funds and return to normal borrowing from the bond markets in short order which would reduce pressure at EU level considerably, at least staving off disaster temporarily (Fouquet 2010). Conversely, if investors cannot forecast, in the worst case scenario, whether peripheral nations will be aided sufficiently (whether with one, two or twenty bailouts) then evaluating perceived risk becomes impossible and unattractively costly. Addressing this risk can be futile. In February 2010, Luxembourg Prime Minister Jean-Claude Juncker, the head of the Eurogroup of finance ministers, stressed that Spain and Portugal pose no risk to eurozone stability, implying indirectly at that time that the situation with Greece is the exception rather than the rule.[36] When Ireland requested a bailout in November, this argument had already lost resonance with expectant investors, further losing resonance when Portugal followed suit in March 2011.

The stringent position of ECB head Jean Claude Trichet while reflecting the importance of avoiding moral hazard, is deliberately understating the problem. Arguably, it was an equally stringent approach by the US Bush Administration which permitted the collapse of Lehman Brothers and ushered in speculative panic

[36] Anonymous (2010). '*Alarm spreads over eurozone deficits.*' Business Times. Monday, February 8, 2010.

on global financial markets. This is something the ECB clearly fears. The after effects of Lehman in hindsight were disastrous and the decision an historically bad mistake[37](Cooley, 2009 Johnson and Kwak 2009). The EZ-17 can effectively choose a wise Bear Sterns approach or a calamitous but morally justifiable Lehman's approach. Ultimately, adopting the Lehman's approach will likely result in Lehman 2.0 in Europe, with nations on the chopping block rather than Wall Street investment banks.

The ECB's current approach can be accused of merely allowing speculation to continue unabated and relegating responsibility for Greek and Irish bonds to the credit rating agencies, agencies implicit in the sub-prime mortgage bond debacle (Irvin 2010). How much is deliberate stalling for time and how much is a reflection of incoherent structures in place is not certain. One thing is certain – the issue of the euro has been relegated to minor importance amidst the threat of national defaults. Its failure is predominately emblematic of the indecisiveness of political leaders in relation to economic governance but it not symptomatic of the current crisis.

[37] It was only days later when the US Federal Reserve ultimately intervened and rescued insurance giant AIG.

Conclusion

Ultimately, by making reference to the weaknesses, *politically* speaking, of EMU, euro 'survivalists' win the debate. However, the debate shouldn't be about survival, It should be about overhauling the current weak structure of EMU and reforming how the euro operates. Trouble is that the EZ-17 can no longer 'kick the can down the road' because ultimately, they've found the can they kicked in the early 1990s and they're running out of road – political road. Undeniably, new economic governance is now an imperative but this is an intensively political situation heavily influenced by superfluous factors within the member states. We are now in the post-Maastricht Criteria phase of EMU. The requirement for mechanisms such as a treasury for the ECB, a European finance ministry, stronger redistributive institutions and a far stricter SGP may provide the eurozone with the coherence required to manage through the storm.

The economic theory is sound, it just doesn't really apply. For the eurozone, it's the ultimate politicking which is tortuous and acrimonious. This crisis may indeed provide the catalyst for a reassessment and reassertion of eurozone political will, which should underwrite economic fundamentality. John Stuart Mill, writing in 1848, described multi-nation currency unity as the penultimate result of a process of 'political improvement,' a development which is inherently imperfect.[38] Imperfections require adjustment, not surrender. While EMU and the wider EU project is a complex mix of weak economic logic, political expediency and wishful thinking, as my argument suggests, the protagonists are correct and the euro will continue.

[38] Mill, J.S (1848). '*Principles of Political Economy, Volume II.*' London. Book III, Chapter XX p. 175

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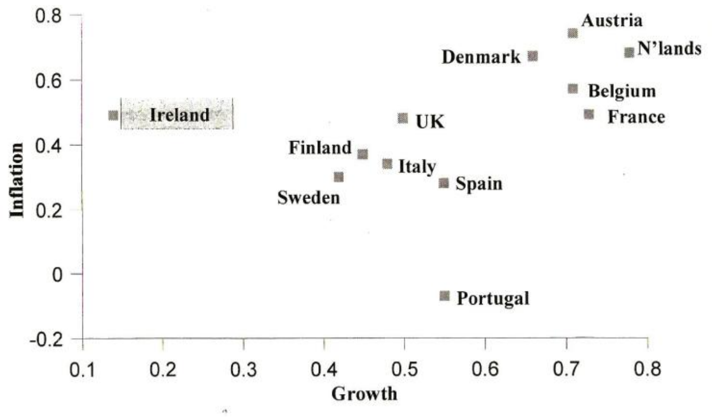
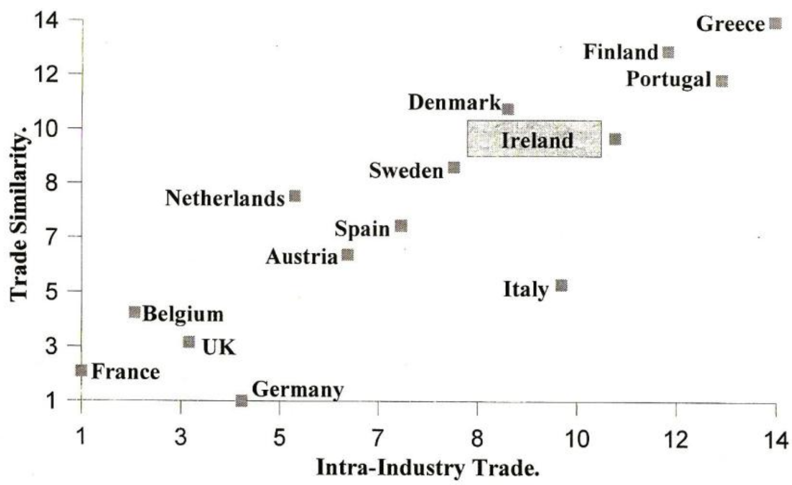
Appendices

Appendix 1: OCA Evidence and EU members at the time of Maastricht (1993)[39]

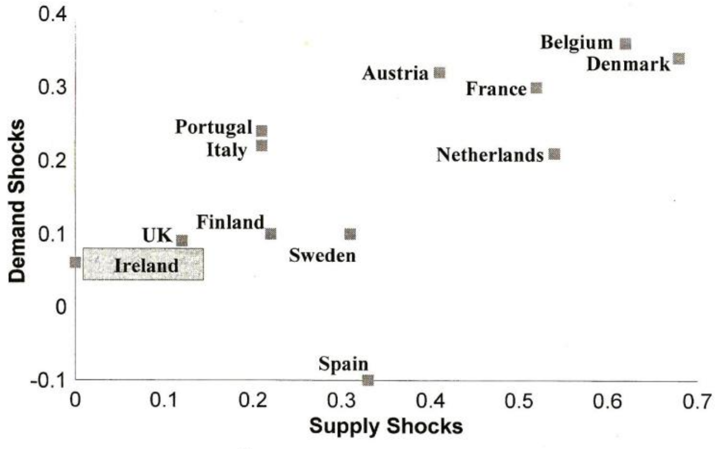
Inflation and Growth: Correlations with Germany



Ranking By Trade Structure

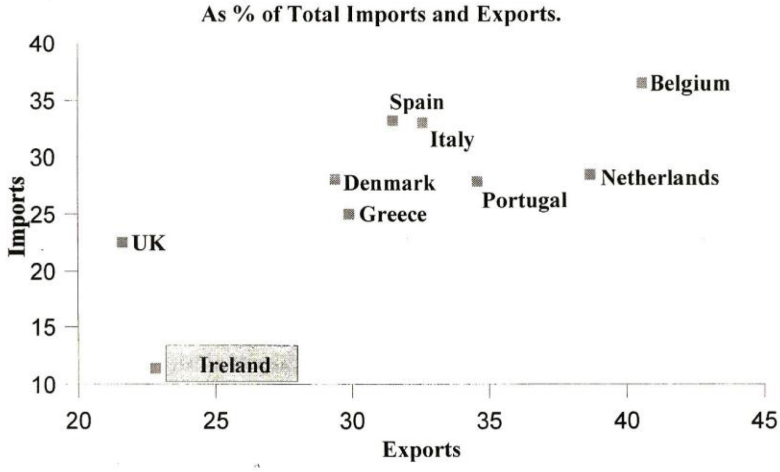


Business Cycle Synchronisation



[39] All figures are extracted from: Neary, Peter and Thom, Rodney (1996) '*Punts, Pounds and euros: In search of an optimum currency area*.' Centre for Economic Research. Working Paper Series. October 1996 and Gros, D (1996). *'Towards Economic and Monetary Union: Problems and Prospects.'* Brussels, Centre for European Policy Studies, Paper no. 65

EU Trade with Germany and France (1993)



Appendix2: The German-Greek Media War (2010)

The Medias Interpretation of German-Greek Relations the midst of the Greek Deficit/Debt Crisis[40]

[40] West, Karl (2010). '*Man who broke the Bank of England, George Soros 'at centre of hedge funds plot to cash in on the fall of the euro.'* The Daily Mail. 27 February 2010.