Performance and Risks in the European Economy

Disequilibria Management at the Euro Area Level

Camelia Milea[1], Floarea Iordache[2], Alina Georgeta Glod[3], Adina Criste[4], Iulia Lupu[5]

[1] *Financial and Monetary Research Centre „Victor Slăvescu", camigheorghe75@gmail.com*

[2] *Financial and Monetary Research Centre „Victor Slăvescu", alina.glod@gmail.com*

[3] *Financial and Monetary Research Centre „Victor Slăvescu", alina.glod@gmail.com*

[4] *Financial and Monetary Research Centre „Victor Slăvescu", cristeadina@yahoo.com*

[5] *Financial and Monetary Research Centre „Victor Slăvescu", iulia.lupu@gmail.com*

Abstract. The current crisis has shown that an economic integration through a political and monetary approach is wrong. It seems to be more appropriate a social and economic approach, meaning both a better preparedness of the new countries joining the euro area and more flexibility of the economic structures of the old members of the euro zone, in order to make the more "harmonious" the way of the monetary area operation. For that purpose, this article has made an analysis of the imbalances management issue in the euro area in order to provide a few theoretical solutions for a better functioning of the Economic and Monetary Union (EMU), based on the observation of developments in the euro area countries. This paper enriches the economic literature, but also it is relying on the research workings made by the authors in the field of European integration. The originality of this article arises from the extremely topical issue examined and its way of approach, but also from the conclusions outlined.

Keywords: financial - economic crisis; disequilibria; macroeconomic imbalances; European integration

1 Introduction

The euro area is composed of countries that, over the years, have developed divergences caused by the differences regarding economic structures, fiscal policy conduct, or the level of economic development. The difficulties faced in the recent years by the euro area, particularly by those countries from the periphery, put into the question the stability of the European monetary zone functioning. Promoting the idea of monetary unification has considered both a political goal (that to boost integration) and an economic one – according to which a monetary integration would stimulate the economic convergence, too. The global financial and economic crisis has created new challenges for the euro area authorities, hampering further the resolution the existing macroeconomic imbalances.

2 Divergences between the Euro Area Countries before the Current Global Financial and Economic Crisis

During 1980-1990, the convergence process (the so-called "convergence play") experienced by the euro zone countries from the periphery (Spain, Portugal, Ireland, Greece) has generated overheating of these economies, a phenomenon which has maintained after the euro adoption, under the common monetary policy, which has pro-cyclical effects for these countries[1]. Furthermore, large economies such as Germany, France or Italy have not enjoyed spectacular economic growth, either before or after euro adoption.

Some divergences, including those regarding economic growth, have partly reflected economic catching-up process made by countries from the periphery. But within this group, there are also important differences expressed over a long period of time. If in Spain and Ireland[2] the employment rate and economic growth level were above the average for the euro area both before and after euro adoption, in Greece the employment rate has remained relatively low, in spite of a robust economic growth, after the accession to the EMU. The Greek government has shown, for a long time, a fairly relaxed behaviour concerning spending, and this behaviour has been enhanced when Greece joined the euro area, paying lower interest rates on government bonds, adapting to this situation by increasing public spending. The interest rates have been sustained due to the implicit warranty from the stronger countries, as they are expected to support poorer countries in difficult times (by reducing the risk premium[3]).

Some euro area countries have not capitalized the opportunity of achieving a sustainable speed-up of fiscal consolidation. Euro adoption was considered an effective and sustainable way to reduce or stabilize inflation and interest rates, which in turn would have supported the consolidation of public finances by reducing the risk premium paid to the very high debt service. Also, the macroeconomic framework of the monetary union, oriented towards stability, should have reduced uncertainty and increased confidence, which would have led to a more efficient allocation of resources and hence to a greater potential of the economy. Long-term growth should have also benefit from the development and the increase of trade within the euro area, based on greater transparency of relative prices induced by the existence of a single currency. By contrast, Italy's and Portugal's fiscal policy was unsustainable, because it did not seek mitigating cyclical fluctuations. In both countries it was directed towards expenditures, in particular towards personal expenditures, and the effects have been also felt on the labour market, generating large increases in public sector employment and wages - often excessive compared to the private sector. By the allocation of resources towards the public sector, resulting from this process, the fiscal policy has exacerbated the fundamental imbalances.

[1] To stimulate the economies of Germany and France who have faced a recession, the ECB has applied lower nominal interest rates, which have affected the economies of countries like Portugal, Italy, Greece, Spain, which already were suffering from inflationary pressures due to economy overheating. In fact, this contradiction is generated by the business cycle divergences: on the one hand, the big countries in the region had a period of economic slowdown and, on the other hand, peripheral countries went through a period of rapid economic growth. Although the performance of the German economy was not significant in terms of growth, it has benefited from the opening of markets of Central and Eastern European countries, investing heavily in this region, so that its comercial relations with the outside world has increased significantly compared to other countries (like France or Italy).

[2] Besides the initial shock of interest rate (in 1998-2000), connected with the euro area entry, which has been combined with a pro-cyclical fiscal loosening, the Irish economy has been influenced by specific shocks of euro zone, caused by differences regarding trading partners, the structure of industries or sectoral specialization.

[3] After the euro adoption in Greece, the risk premium of long-term government bonds against the average at the Euro zone level fell rapidly from 500 to 100 basis points, which accordingly reduced the cost of the existing debt stock.

Another important difference is related to the economy competitiveness. After 1999, the most competitive euro area countries were Germany and Austria, but France, Belgium, Luxembourg and Finland have maintained good levels of competitiveness. By contrast, Greece, Spain, Ireland, Italy, Portugal and the Netherlands have suffered damages of their competitive position. The deterioration of the competitiveness of euro area countries, triggered by the financial and economic crisis in 2007, especially of those on the periphery, has serious and sluggish negative effects on the long-term term.

The euro adoption, instead of leading to an improvement of conditions in the euro area countries, has generated a number of divergences, which have widened macroeconomic imbalances, especially the fiscal and budgetary ones, as pointed out by the deviations from the nominal convergence criteria provided by the Maastricht Treaty.

The convergence criterion for inflation is monitored only before the euro adoption and therefore we may wonder if this criterion has been successful in reducing the inflation permanently.

Greece has fulfilled this criterion shortly before the evaluation from 2000 and only a few months after. For seven years, it is above the reference value. Portugal and Spain have been several times over the benchmark. In these three countries, like the new member states of the European Union, the price level is below the EU average. Ireland is "more expensive" than the European average, but it has higher economic growth, compared to the other old EU Member States, similar with the new Member States. This economic growth was accompanied by inflation, often exceeding the acceptable limits. In the EU15 group, Greece, Ireland and Spain had the highest inflation rate, and ten of the EU15 countries had inflation rate over the Maastricht criterion several times in 1999-2007. In Belgium, Germany, Austria, Sweden and UK, the inflation rate has not been above the Maastricht criterion in this period. According to IMF document[1], these countries are not fully successful: they recorded a low inflation, but on the expenses of a slower economic activity, far below the potential of GDP. Britain is the only country, which made exception from this rule.

Developments of the fiscal indicators in the old EU Member States have been mixed. Most of the EU15 countries have exceeded the reference values regarding fiscal positions; Denmark, Ireland, Luxembourg and Finland are the only countries that register levels below these limits for both indicators (budget deficit and public debt) during the period 1999-2007.

In 2007, the budget deficit of the EU15 countries did not exceed 3% of GDP, situation which has not been repeated since 2000. Most exceedings of the budget deficit criterion occurred in 2003-2005, and Germany, Greece, Italy and Portugal have exceeded this value more often.

The public debt criterion has been exceeded more often compared with the budget deficit one. Belgium, Greece and Italy have a public debt on GDP of more than 60% in all the years since the euro adoption, and Austria has registered only a slight decrease in 2007, being very close to the limit, with a rate of 59.1%. In Denmark, Ireland, Luxembourg, Finland and Britain the public debt levels were below the reference value, throughout the whole period.

Overall, except the interest rate criterion, all the countries have passed over at least once the benchmarks for rest of indicators (inflation, budget deficit, public debt) during 1999-2007. Denmark[2], Finland[3] and Sweden[4] are countries with the best developments, facing only one over fulfilment. On

[1] IMF Working Paper, *The Maastricht Inflation Criterion: How Unpleasant Is Purgatory?*, Aleš Bulíř and Jaromír Hurník1, June 2006.
[2] In 1999, the inflation rate was 2,1%, compared to the reference value of 2%.
[3] In 2000, the inflation rate was 2,9%, compared to 2,7%, the reference value.
[4] In 1999, the public debt to GDP was 65,6%, compared to the reference value of 60% of GDP.

the next position is Britain[1]; which exceeded three times the reference values. Of this group of four countries, only Finland is a member of the euro area (Figure 1).

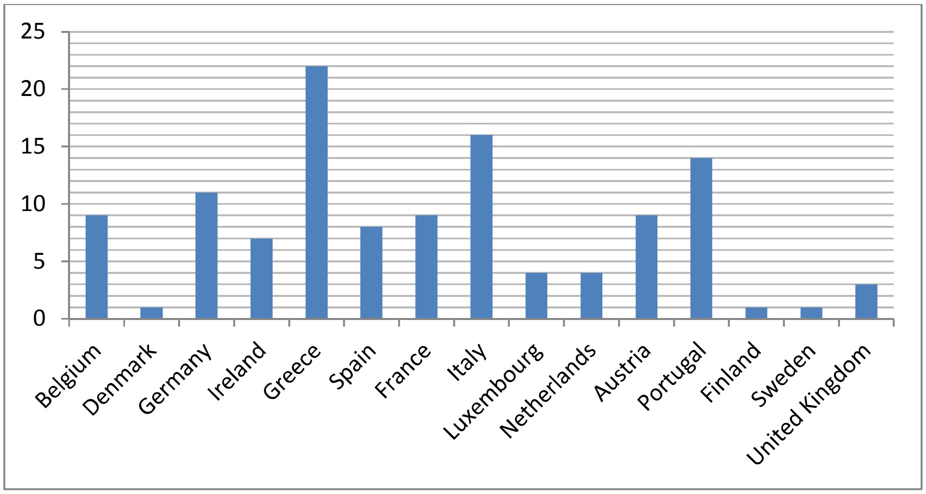

Figure 1. Total exceedings of benchmarks in the period 1999-2007

Source: Eurostat statistical data and author's calculations

How does this situation affect the entry of the new Member States into the EMU? An obvious conclusion is that these countries are entering a world that works, basically, a lot differently than people think. It appears that fiscal discipline is not observed, and sanctions were shown not to be credible once a country was in the Economic and Monetary Union. Such a situation may increase the interest rate and exchange rate volatility that may have adverse consequences for newcomers. This may weaken the motivation for adopting the tax rules in the new EU Member States. What happened in the fiscal field makes EMU less attractive for the candidate countries to the euro zone. It seems that the problem basis lies in adopting some political decisions inside the ECOFIN Council regarding the application of the rules. Every minister of finance in power knows that he can always deal with an excessive deficit in his country, which can be a powerful incentive to forgive colleagues who currently face such problems, expecting that, in future, he would receive a similar treatment from them[2].

If we look at the motivation of introducing fiscal convergence criteria, they are justified by the fact that a high public debt may trigger a tendency to cover that debt by issuing money, therefore, engendering inflation; and budget deficit increase generates pressure on public debt, and on inflation, too, through the aggregate demand. Therefore, the fiscal-budgetary criteria are built on the model to stabilize public debt to 60% of GDP, in conditions of economic growth of 5% and a level of budget deficit of only 3% of GDP. This model is no longer justified today; the debt level of 60% of GDP, was representing the average ratio of government debt to GDP in the European Community, in the late 80's. But if we look at the developments in the economic growth only between 2005-2008, (i.e. until the explosive manifestation of global financial and economic crisis), we see that, on average, it was around 2%, the budget deficit stood on average at 1,6% of GDP, and public debt was 68,4% of GDP, on average. In this view, we discover slippages regarding both of the fiscal-budgetary criteria, being perhaps more useful to reconsider the values of these criteria at the EU level, or at least for one of them. As we can notice in the recent years, the economic growth is very modest in the euro area, and

[1] In 2003, 2004 and 2005, the government deficit to GDP reached 3,3%, 3,4%, respectively 3,4%.

[2] A well known case is that of Italy in 2004, when it did not receive any warning, due the support of France and Germany, which did not enter the excessive deficit procedure, the fall before, thanks to the support of Italy.

the budget deficits have increased dramatically in all member states of EMU, and probably will record also a substantial growth in the coming years. Therefore, it should not surprise us that the public debt level will exceed the required level in the euro zone countries.

The current situation raises the question of macroeconomic imbalances management in the monetary union in order to maintain unity and stability in the euro area, to determine how the European Central Bank (ECB) can provide support if one of euro zone states are facing a more or less severe crisis.

3 The Crisis in Greece - Testing the Viability of the Euro Area Functioning

When the financial crisis began, deficits in euro zone countries have deepened (both those in developed countries and in those poorer). Developed countries have their own problems, creating a mistrust feeling that they could help poorer countries in such a situation. Moreover, the gap between the interest rate that Greece must pay for its bonds and the corresponding rate for German bonds rose, highlighting the divergent developments in the euro area economies. At present, the question which arises is whether Greece will be assisted by the others members of the euro area, considering that it would be violated the clause of "no bail out" from the Maastricht Treaty, relating to the national debt[1] (the relatively easy access to loans or government financial aid could create a phenomenon of "moral hazard").

The Greek crisis has shown that the ECB has no formal instrument to help any country in difficulties. Thus, as investors became increasingly alarmed with the high level of indebtedness of Greece, Spain and Portugal, the crisis has revealed the fundamental weaknesses of the monetary union. The European Central Bank, unlike the Fed, can neither buy government bonds nor provide direct support to national central banks in difficulties. However, during the recent global financial crisis, the ECB demonstrated that it can be creative in finding ways to support the European banking system, extending massively loans to central banks, helping them to avoid an even worse credit crisis.

The ECB policy permits acceptance of government bonds as collateral for the lending operations, based on an assessment of credit rating agencies. In the present situation, the ECB helps Greece by accepting its bonds as collateral, which is used by Greek banks to borrow money. As long as Athens maintains its current credit ratings, the Greek bonds issuance is consistent with the ECB rules. But if the situation will worsen, the European governments will be those who will have to find a way to help Greece or other distressed countries. Although they withhold from any gesture that would encourage borrowing and excessive government spending, EU states have left to be understood that they would do everything they can to prevent any euro zone country to entry into default.

If the ECB would not accept these bonds as collateral for loans, countries with fiscal-budgetary problems would have to pay higher interest. Thus, it might be considered that they are supported by a process of bail out, other countries paying the "bill" of their debts.

For euro area countries, the costs of a reckless fiscal behavior may also be outsourced to a certain extent. Any government whose bonds are accepted as collateral by the ECB may use this method of

[1] Under the "no bail out" clause, the European Central Bank is prohibited to assist a country facing fiscal difficulties, through an accommodative monetary policy. Such a measure is intended to eliminate the possibility of a liquidity crisis throughout the euro zone, when a country becomes insolvent, and the ECB would be forced to inject an amount of inflationary liquidity across EMU.

"printing money" to finance its spending[1]. The costs of this strategy are partly outsourced to other countries, when the newly created currency causes an inflammation of prices throughout the monetary union, encouraging governments to accumulate bigger deficits than the rest of the euro area. Therefore, in the Eurosystem there is an incorporated tendency toward a purchasing power decrease, which can eventually cause the collapse of the euro.

Solving these problems requires a strong political support to ensure that member states comply with the limits imposed by the Treaty (the need for political union[2]). Otherwise, the responsibility for solving the problem is to the ECB President, since only he has the authority and expertise necessary to manage the crisis. The Maastricht Treaty does not allow, formally, the ECB to help individually any euro area member when it has problems. This provision is for the reason that countries should not be tempted to spend more than their means, thus causing inflation that would be supported by the other member countries. The underlying EMU Treaty does not contain rules on how to tackle the situation in which one member is having difficulties. The countries that have adopted euro gave the ECB all powers related to developing and implementing their monetary policy. They have kept only those attributions related to the fiscal policy, which coordination and monitoring is set by the Stability and Growth Pact (SGP). Related to this, it is important to note that each country needs to have a sound fiscal policy. The same Treaty does not allow the appointment of a single finance minister for the whole euro area. Trichet has not at its disposal a strong central government to support the euro. Currently, the European Council, which represents the governments of the EU27 member states, has - for the first time in the history - a stable president in the person of the Belgian Herman Van Rompuy. But he has little power to "discipline" the 16 euro area members.

Furthermore, the ECB has no authority to manage the delicate mix of incentives and threats that should accompany the measures to assist the EMU countries. In 2009, while in some countries from Eastern Europe (Latvia, Hungary and Romania) economic growth had collapsed, the authorities in Brussels have let the International Monetary Fund to help them. Instead, EU leaders do not want the IMF bailout, when the euro area countries are facing such problems. A solution of the European Commission is to bring into existence a European Monetary Fund (EMF) to assist countries in the euro area, when a member state enters into the insolvency proceedings. This institution should have the same power of intervention as IMF. Creating EMF would represent an important step towards European economic integration, which currently lacks the "technical device" to support those countries in need, especially in the fiscal budgetary area.

Greece's placement under the guardianship of the European Union, due to the debt crisis, is an unprecedented act in the EU, and could mean the restriction of the member states budgetary sovereignty. Thus, we are in the "phase of invention", which could create a precedent in budgetary surveillance. The question is whether the same firm position will be adopted in the case of large countries such as France or Germany.

Although there are concerns that one of the implications of this global financial and economic crisis would be the reduction of budgetary sovereignty for EMU countries, however, a country's surveillance may represent a materialization of strengthened economic governance.

The Stability and Growth Pact, which limits the national budgets deficits, has not so far produced the expected results. In fact, the effectiveness of the SGP was cancelled by the economic crisis.

[1] Similarly, FED usually finances government deficits. The difference between the U.S. and Europe is that the U.S. government is the unique government who calls the FED to finance its expenditure.
[2] This is regarded as the biggest reason behind all the euro area problems.

Another consequence of the budget problems for some euro area countries (Greece, Italy, Portugal, Spain, Ireland), is the enhanced speculations on financial markets, which put pressure on the single currency (euro) by its depreciation, and diminish the confidence in this currency.

Thus, in recent years there has been an apparent shift of "targets" of the speculative operations, from the individual situation of the member states of the euro area with problems, to the euro currency. The fears and the speculations of investors regarding Greece's ability to refinance its debt hit the euro currency, contributing to its depreciation against the U.S. dollar at a minimum level of the last year.

Speculative investment funds have made significant profits from transactions involving securities issued by Greece and from providing "insurance" against the default risk of Greece, complicating even more the difficult financial situation of this country and generating additional pressure on the euro exchange rate.

Another effect of the debt crisis of Greece refers to the delay, with at least one year, of joining the euro area for emerging EU countries; it is anticipated that most of them will adopt the single currency in or after 2015.

A reference point (benchmark) for a better management of the problems of the euro area countries is to create a special unit inside the European Central Bank (ECB), which should be responsible for granting the ratings (both for countries and for companies), creating, in the euro area, an alternative to the large rating agencies such as Fitch, Moody's and Standard & Poor's. The motivation of such a solution means that the rating agencies that have a monopoly in this area put a lot of pressure on markets. It does not exist yet a timetable for the implementation of this project. Although this idea is currently only an intention, there are important signals about the reliability of such concerns, which would end the current domination of rating agencies, all North American. We believe that is not normal that the stability of a euro area country and of the monetary union, as a whole, to depend on the decisions of some rating agencies, especially that they are from outside the euro area.

As a conclusion of the above ideas, we emphasize that the management of problems in the euro area is difficult, taking into account the solutions proposed by the European authorities. It can be foreseen a bleak future of this monetary area, since there are strong incentives for imprudent fiscal behavior, not only from Greece, but also from other countries (in Spain, the official unemployment is almost 20% and the public deficit is 11.4% of GDP; Portugal announced a plan to privatize national assets, with the budget deficit reaching 9.3% of GDP; in Ireland, the burst of the real estate bubble led to a growing public deficit, which reached the 11.5% level). The reckless fiscal behavior of these states is characterized by the tendency to pass the national burden outside the country. In this way it is more convenient to issue government bonds on no economical basis than to increase taxes.

4 Conclusions

The results registered, over the years, by the euro area countries show that a politically forced accession, of those countries that are not economically prepared to meet on the long-term the rigorous and super-strict regulated climate of the euro area, causes significant disruption in the functioning of the economy.

The Greek crisis is, so far, the most significant challenge for the single European currency and for the economic unity of the continent.

The first major EMU crisis caused by Greece revealed a structural problem of the euro area that is considered to be solved, namely, through a single European government to support the ECB decisions.

The current situation in the euro area splits the region in two parts: on the one hand, poorer countries consider that, in this difficult period, it can be tested the solidarity of the monetary union, and on the other hand, the developed countries of the euro area point out that it should not be violated the “no bail out” clause.

In the context of the global financial and economic crisis, on the medium and long term, it can be drawn a number of risks which could seriously affect the economic growth in the EU and in the euro area, in particular. Among these risks can be mentioned the following: the possibility of an economic recovery without an improvement of the job creation, therefore a persistent long-term unemployment; maintaining or widening imbalances in public finance by increasing debt and budget deficit in the member countries; the inability to return to previous levels of the potential economic growth, registered before the crisis, by permanent change of financial and banking landscape, in which it can be noticed tighter financing conditions, in the conditions of an increased risk aversion and of a need for debt recovery.

The current economic development in the euro area highlights the need for a sound fiscal policy in the euro area countries and for a better coordination of economic policies within EMU.

The analysis results show that forming a currency area is neither a necessary nor a sufficient condition for a healthy economic growth. The convergence criteria underpinning the EMU edifice seem to be rather a stiff monetary arrangement, which affects the flexibility of the macroeconomic policies.

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