# The crisis of the EMU

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**- Peter A. Schmid[1] -**

**Abstract**

The Euro Zone (EZ)'s economies are under great stress since last decade's financial crisis. Diverging interest rates, high debt burdens and sluggish growth in several member countries led to various rescue activities. Nevertheless, financial markets have still not calmed and the break-up of the EZ is discussed openly. Contrary to the popular belief I show that the Euro itself has been a success story so far but the EZ suffers under a debt crisis and huge economic imbalances. An overhaul of the EZ's institutional framework, however, is necessary.

**Keywords:** financial crisis, Euro crisis, current account imbalances, monetary union

**JEL-classifications:** E42, F34

## 1. Introduction

The future of the common currency in the EZ (EZ) is at risk and there is an open debate in politics and the academic world whether the European Monetary Union (EMU) can survive in its current form (Roubini/Ferguson [2012], Subacchi/Pickford [2012]). Even before its start in 1999 there were many critics that warned that the greatest experiment in monetary history is set to fail due to the violations of the required conditions stated by Mundell [1961] for the functioning of a common currency area; it was even suggested that the EZ might carry political risk that was meant to be eliminated by the common currency (Feldstein [1997], Friedman [2007]).

Some political observers now speak of peace and war concerning the EMU (Steigert [2010]) and that its success is pivotal for the survival of the European integration. The former German chancellor Kohl even stated the issue of containing a potentially dangerous Germany within the EMU as a receipt for peace in Europe. Unfortunately, this rhetoric complicates or even prevents a serious debate on the current state of the EMU and its associated challenges as it is well known that *the truth dies first in times of war*. This article's aim is to give an unbiased summary of the *status quo* of the Euro and shed light into the roots of the current turmoil on financial markets concerning the EZ. I conclude that the EMU is in deep economic crisis but that there is no currency crisis although the common currency might have been favourable to the economic imbalances within the EZ.

## 2. The performance of the Euro – Hard facts on its History

Most commentators and academics speak of a Euro crisis now (The EEAG Report [2012]). Nevertheless there are still voices that question the existence of a currency crisis (Klodt [2011]). In fact, a crisis of the Euro cannot be assessed prima facie based on its performance since its birth.

First, the development of the Euro exchange rates does not look alarming. Compared to other major currencies the real effective exchange rate of the Euro even displays a certain strength (*Fig. 1a*). Whereas the US-Dollar, the Pound Sterling and the Japanese Yen lost value the Euro performed and gained comparatively. The real effective exchange rates of the Euro and the US-Dollar even developed contrary to each other which is manifest in a negative correlation of *-0.71*.

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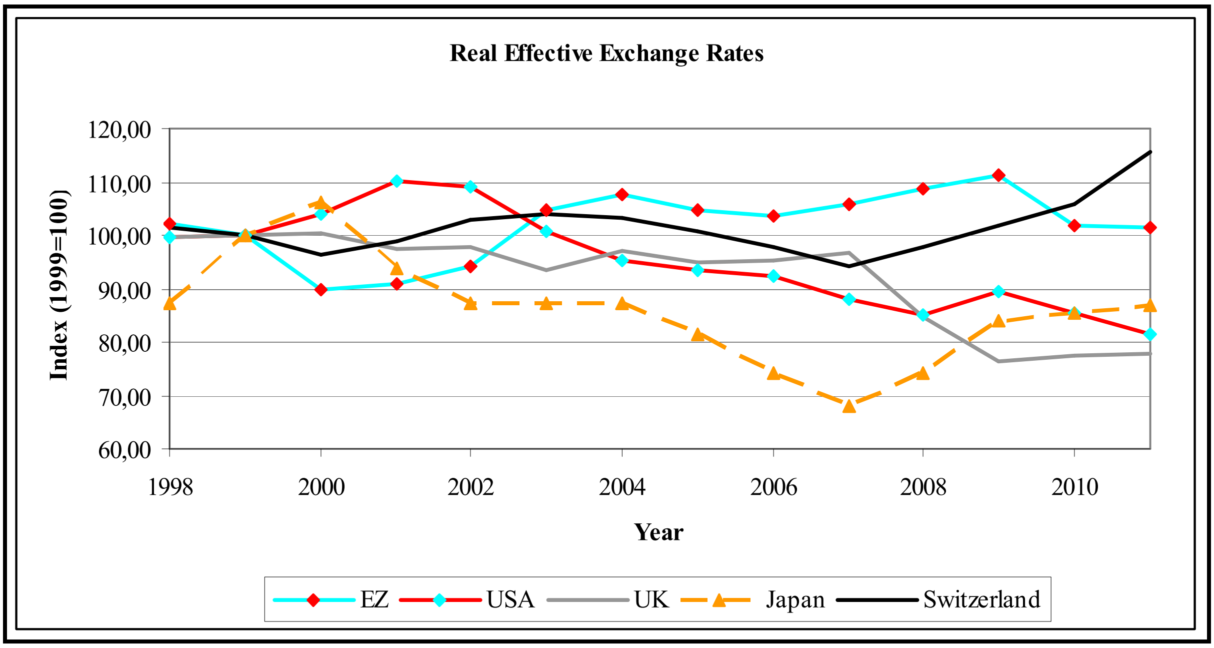


*Fig. 1a*: **Real effective exchange rates based on 41 trading partners, deflator: consumer price indices (Source: Eurostat)**

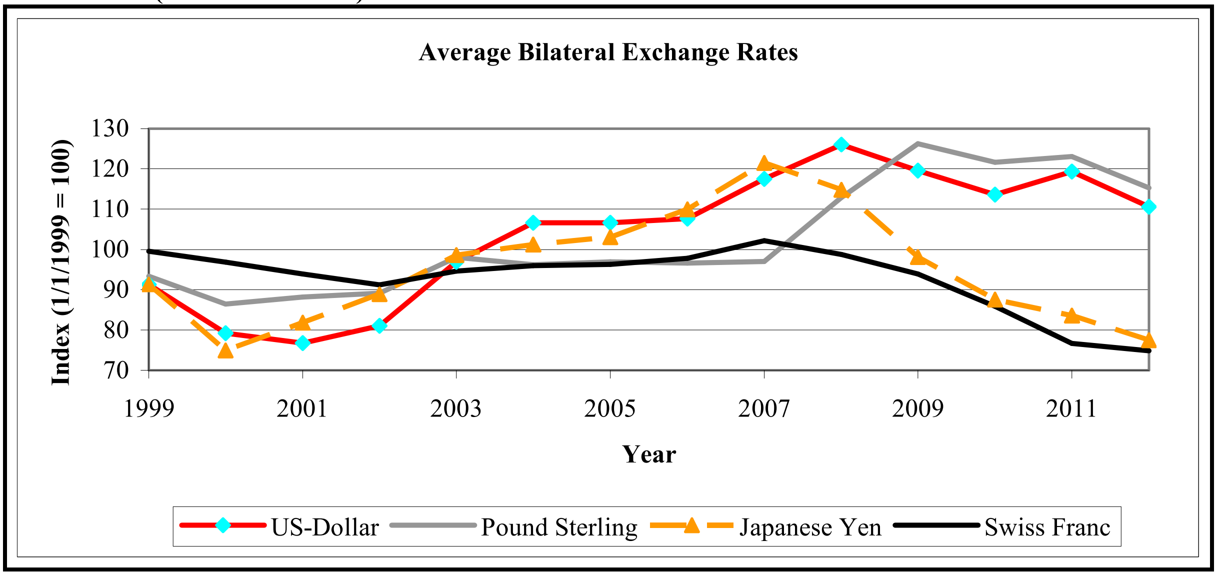


*Fig 1b*: **Bilateral exchange rates of the Euro, forecast for 2012 (Source: Eurostat)**

Moreover, *Fig. 1b* shows major fluctuations of bilateral Euro exchange rates. But these are not unusual by historical standards but which are not unusual in historical standards. The US-Dollar's exchange rate against the Deutsche Mark, for example, fluctuates much stronger around its average for the period 1971 to 1999. In addition The Euro appreciated against the US-Dollar and the Pound Sterling considerably after its decline in the first years of the currency union. The sharp loss against the Swiss Franc and the Japanese Yen only happened after the outbreak of the financial crisis 07/08 and at least the Swiss Franc must be seen as a safe haven which naturally gains in turbulent times. As the Euro also gained value against major trading partners from emerging countries, e.g. +28.2% against the Chinese Yuan and +49.41 against the Indian Rupee from 2000 to 2011, the price of the Euro in units of other currencies does not suggest a currency crisis but describes its relative strength.

Second, overall public debt in the EZ increased considerably from 72.8% in 1998 to 87.2% in 2011 (*Fig. 2*). But it is remarkable that until the outbreak of the financial crisis 07/08 a moderate decrease or stabilization of public debt was accomplished; it only increased afterwards by roughly 20 percentage points. In addition, EZ public debt is still well below the public debt in the United States and Japan that experienced debt hikes from 67.2% to 102.9% in the time period 2007 to 2011 and from 183.0% to 229.8% respectively. Thus, a global debt crisis in developed economies might describe the current situation more accurately than a currency crisis in the EZ.

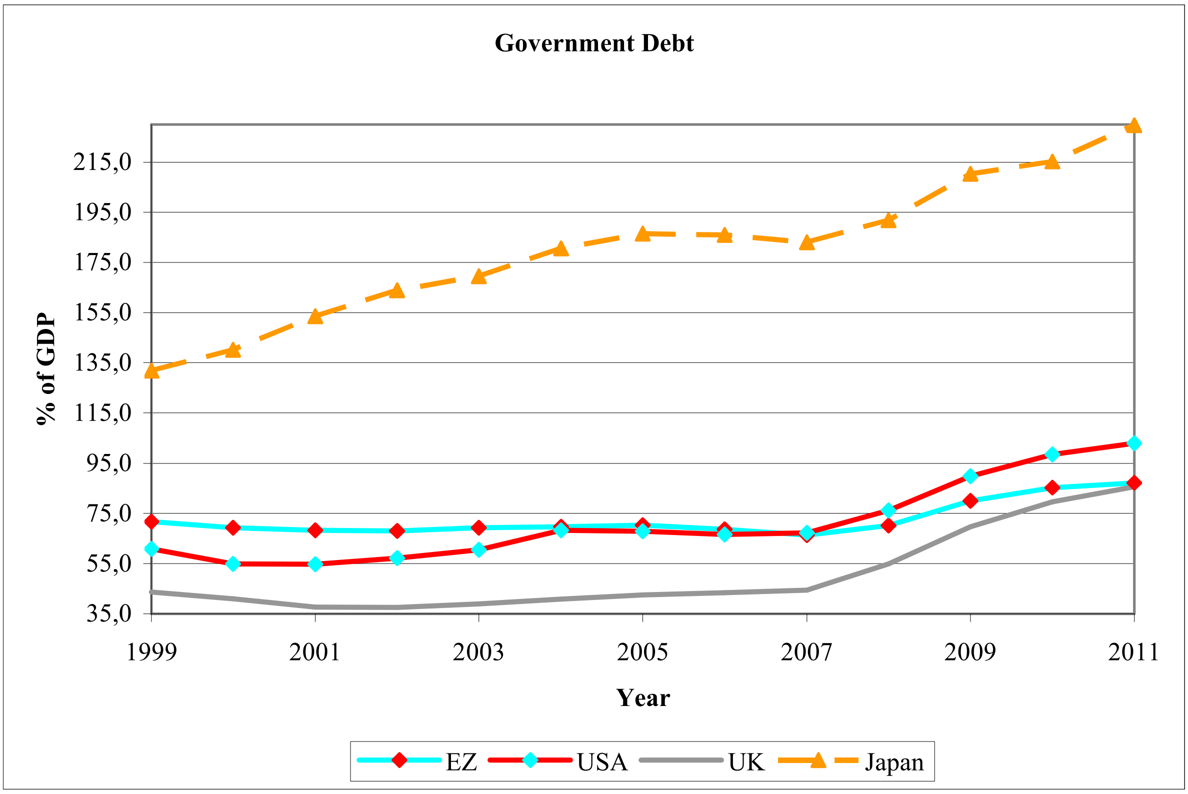


*Fig. 2*: **Public Debt in the EZ, USA, UK and Japan (Source: Eurostat, IMF)**

Third, not only public debt matters, of course. In addition total debt of a country or currency area against the rest of the world must be analyzed. Current account balances can be seen as an indicator for the foreign credit a currency area holds (*Fig. 3*).

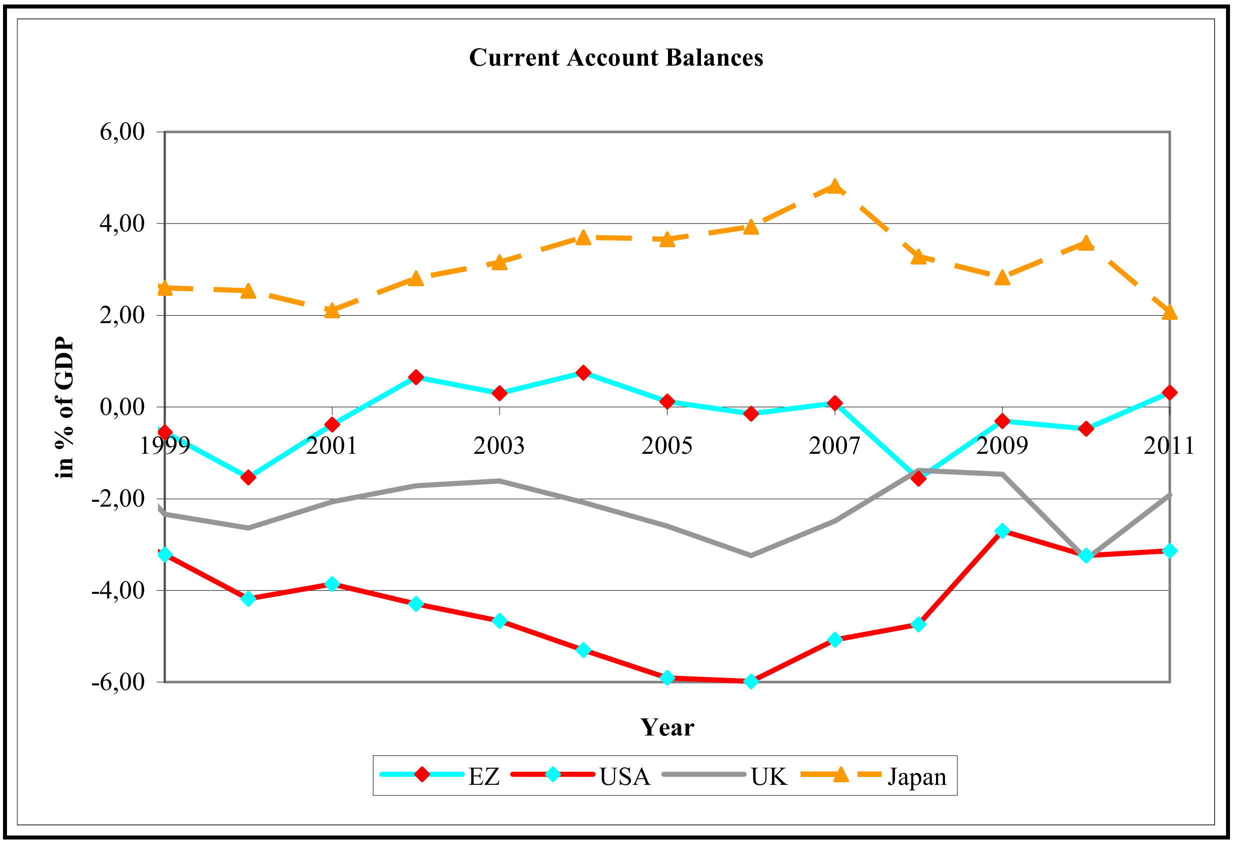


*Fig. 3*: **Current account balances in the EZ, USA, UK and Japan (Source: OECD)**

The EZ looks more or less balanced – in contrast to the United States that still shows high deficits. Since 1999 the EZ's current account balance has been oscillating around zero whereas the US current account was negative for the entire period.

Finally and fourth, the official goal price stability was accomplished in the EZ in a remarkable way. The inflation rate was and is close to its official target rate of 2 % (*Fig. 4*). Moreover, the inflation rate in the EZ was more stable than in the United States and still is well below the UK's and US inflation rate.

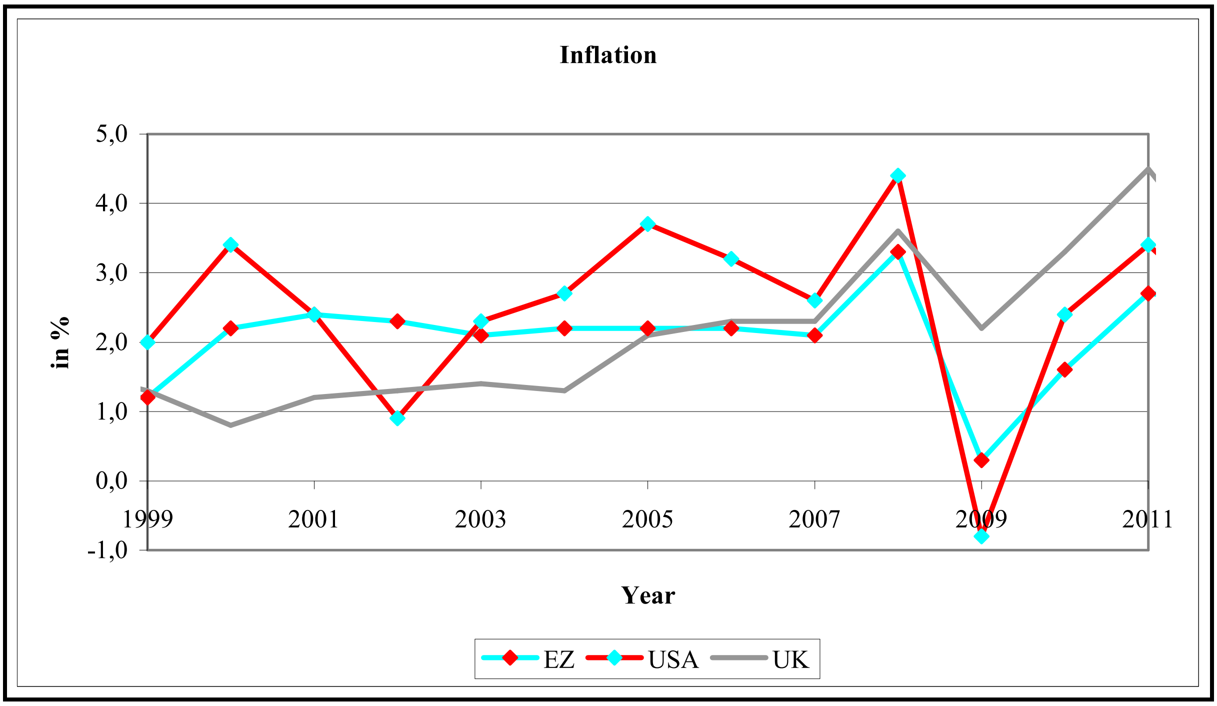


***Fig. 4*****:** **Inflation Rates in the EZ, USA and UK (Source: Eurostat)**

Thus, "although there is no generally accepted formal definition of a currency crisis" (Krugman [2000]), an overall currency crisis must be denied based on the presented hard facts. A closer look at the economic situation in the EZ, however, shows deep trouble because of its imbalances and structural problems. The Euro has not been the reason therefore but created a favourable environment for the diametral development within the EZ.

## 3. Financial Crisis, Real Economic Development and Imbalances within the EZ

The long-term interest rate levels within the EZ narrowed considerably right before and after the start of the EMU (*Fig. 5*) and led to real economic convergence as intended (The EEAG Report [2012]).

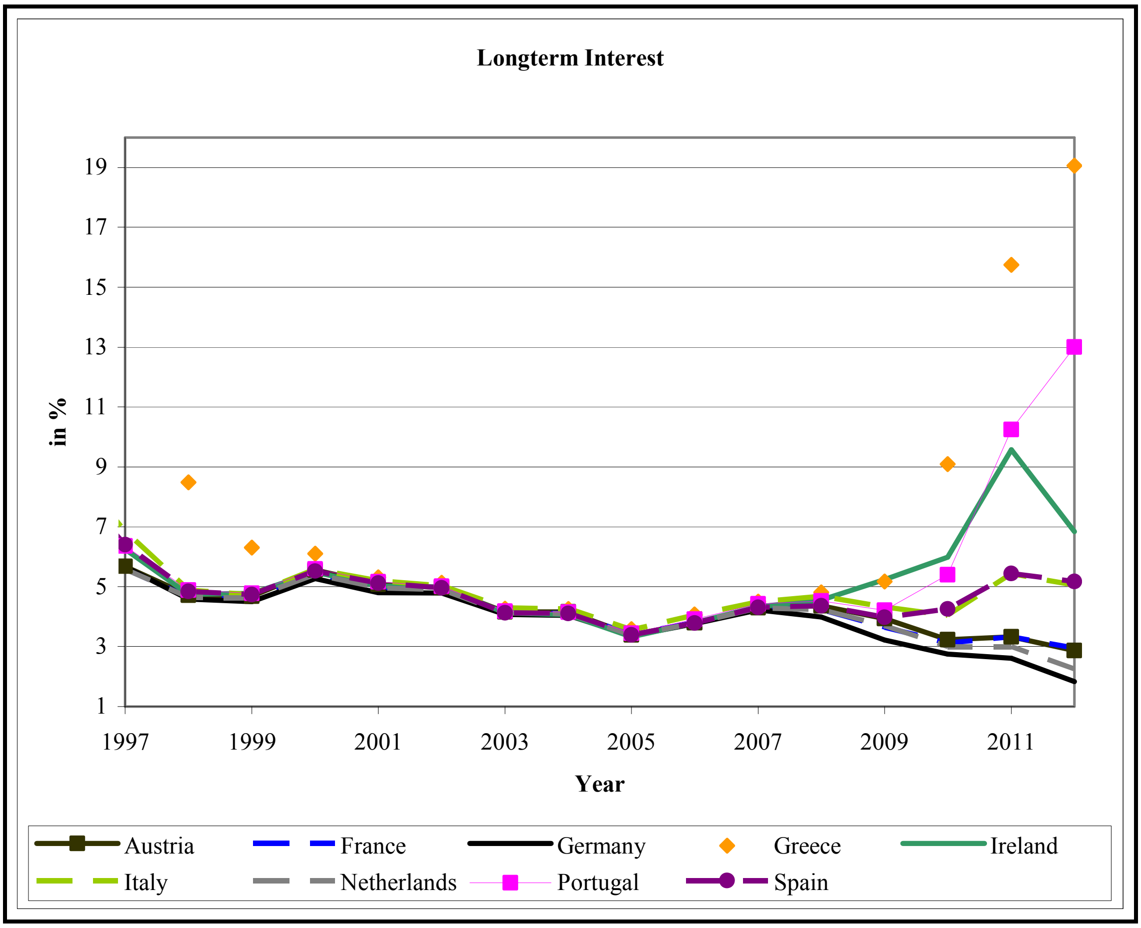


*Fig. 5*: **Long-term interest rates in the EZ, latest value: April 2012 (Source: OECD)**

These low interest rates in Greece, Ireland, Portugal and Spain (GIPS) countries allowed the financing of credit booms. Even worse, as the savings rates in these countries decreased the credit booms were financed by private capital imports (Neubäumer [2011]). Apparently, private investors must have lost faith in the creditworthiness of these countries and the sustainability of the economic catch-up process with the outbreak of the financial crisis 07/08 as interest rates diverged again. At the time of this writing the interest rate spreads reached alarming levels for some countries whereas some countries like Germany can even borrow at historically low interest rates.

### 3.1 Real Economic Development within the EZ

Whereas Germany formed the lower bound of economic growth in the EZ and even was labelled the sick man of Europe (The Economist [2003]) other countries like Spain and Ireland were seen as primes and examples for economic success (Bergheim [2007], Sweeney [2008]). *Fig. 6* shows how GDP per capita converged by differing growth rate patterns within the EZ until the outbreak of the financial crisis 07/08.

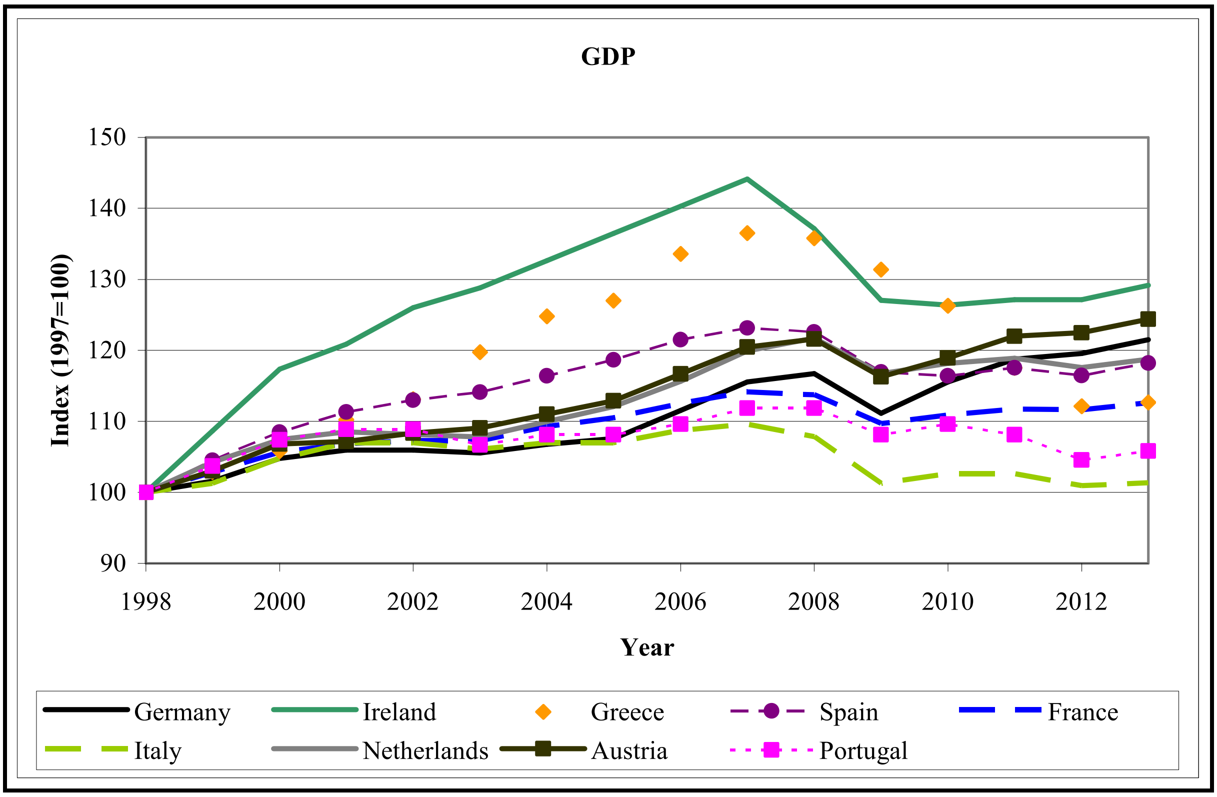


*Fig. 6*: **Development of GDP per capita in the EZ (Source: Eurostat)**

In its aftermath the distribution of economic growth in the EZ reversed completely. Germany, after its structural reforms in the first half of the last century and only moderate growth of unit labor costs, now leads the EZ with strong GDP growth figures. Until 2011 only Austria, Germany, Malta and Slovenia caught-up to the pre-crisis GDP per capita levels. On the other hand the GIPS countries and Italy still struggle and are stuck in economic problems. They either have still been in recession in 2011 and presumably 2012 (Portugal and Greece) or managed only faible growth (Ireland, Italy and Spain). Moreover, there are looming risks that easily can bring back those countries into deep recession (IMF [2012]). Of course, this development is also expressed in unemployment figures (*Fig. 8*):

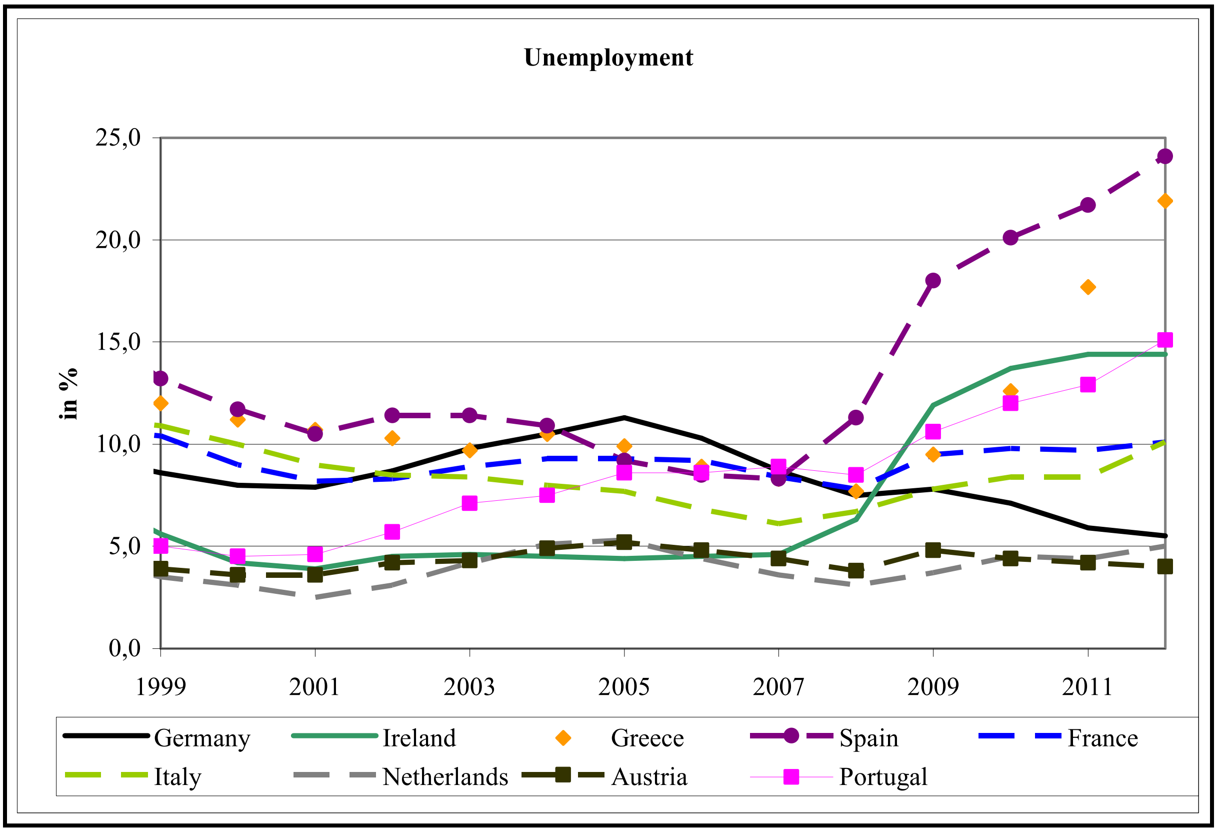


***Fig. 7*:** **Unemployment Rates in the EZ, latest value: March 2012 (Source: Eurostat)**

Whereas there is full employment in some parts of Germany with labor scarcity for skilled industry workers, unemployment in Spain is unsustainable high, especially among the youth (Bräuninger/Majowski [2011]). Although labor migration begins to improve within the EZ and let to a net inflow amounting to 280,000 into Germany (Deutsche Bundesbank [2012]) there is still a strong home bias and a long way to the kind of labor mobility like in the United States (Shambaugh [2012]). Thus, those imbalances do not dampen themselves sufficiently endogenously so far.

### 3.2 Structural Problems and Imbalances within the EZ

This economic heterogeneity within the EZ is summarized in *Tab. 1* that shows the public, private and net foreign debt positions in addition to GDP growth and unemployment figures.

| | GDP growth per capita (1999-2007) | GDP growth per capita (2008-2012) | Unemploy-ment (03/2012) | Public Debt (2011, % of GDP) | Private Debt (2010, % of GDP) | Net Foreign Position (2011, as % of GDP) |
|---|---|---|---|---|---|---|
| **Austria** | 20,5% | 5,0% | 4,0% | 72,2% | 165,7% | -5,58% |
| **Belgium** | 18,0% | 0,0% | 7,3% | 98,0% | 232,7% | 62,61% |
| **Finland** | 33,5% | 1,0% | 7,5% | 48,6% | 177,7% | 13,98% |
| **Germany** | 15,5% | 7,2% | 5,5% | 81,6% | 128,2% | 36,32% |
| **Luxembourg** | 38,9% | -4,0% | 5,2% | 18,2% | 253,9% | 100,53% |
| **Netherlands** | 19,9% | 1,6% | 5,0% | 65,2% | 223,4% | 37,28% |
| | | | | | | |
| **France** | 14,7% | -0,8% | 10,1% | 85,8% | 159,8% | -10,86% |
| **Italy** | 9,6% | -7,1% | 10,1% | 120,1% | 126,4% | -21,80% |
| **Spain** | 23,6% | -4,1% | 24,1% | 68,5% | 227,3% | -92,14% |
| | | | | | | |
| **Greece** | 36,5% | -16,1% | 21,9% | 165,3% | 125,2% | -79,22% |
| **Ireland** | 44,1% | -9,4% | 14,4% | 108,2% | 341,3% | -101,93% |
| **Portugal** | 11,9% | -4,6% | 15,1% | 107,8% | 250,2% | -102,71% |
| | | | | | | |
| **Cyprus** | 22,6% | 3,2% | 10,0% | 71,6% | 278,1% | -80,67% |
| **Estonia** | 90,4% | -1,0% | 10,8% | 6,0% | 176,7% | -57,03% |
| **Malta** | 6,8%[2] | 7,1% | 5,8% | 72,0% | 212,0% | 6,55% |
| **Slovakia** | 54,5% | 20,8% | 13,9% | 43,3% | 69,0% | -64,49% |
| **Slovenia** | 46,4% | 1,0% | 8,6% | 47,6% | 128,8% | -38,59% |

***Tab. 1*:** **Economic Situation in the EZ (Source: Eurostat)**

Besides the differences in growth rate patterns the debt positions are worrying. Nine out of 17 countries show combined debt levels over 250 % and seven countries have a net foreign position below -50 % of GDP. Especially the countries that already receive international help are among both groups, a fact emphasizing the uncertainty or doubts about near economic revival. Only Italy with its low private debt, a combined relative debt level comparable to the French one and its relatively low net foreign position looks promising.

[2] For Malta the accumulated growth rate 2001-2007 is shown.

The development of relative debt levels over time is displayed in *Fig. 8* and *9*:

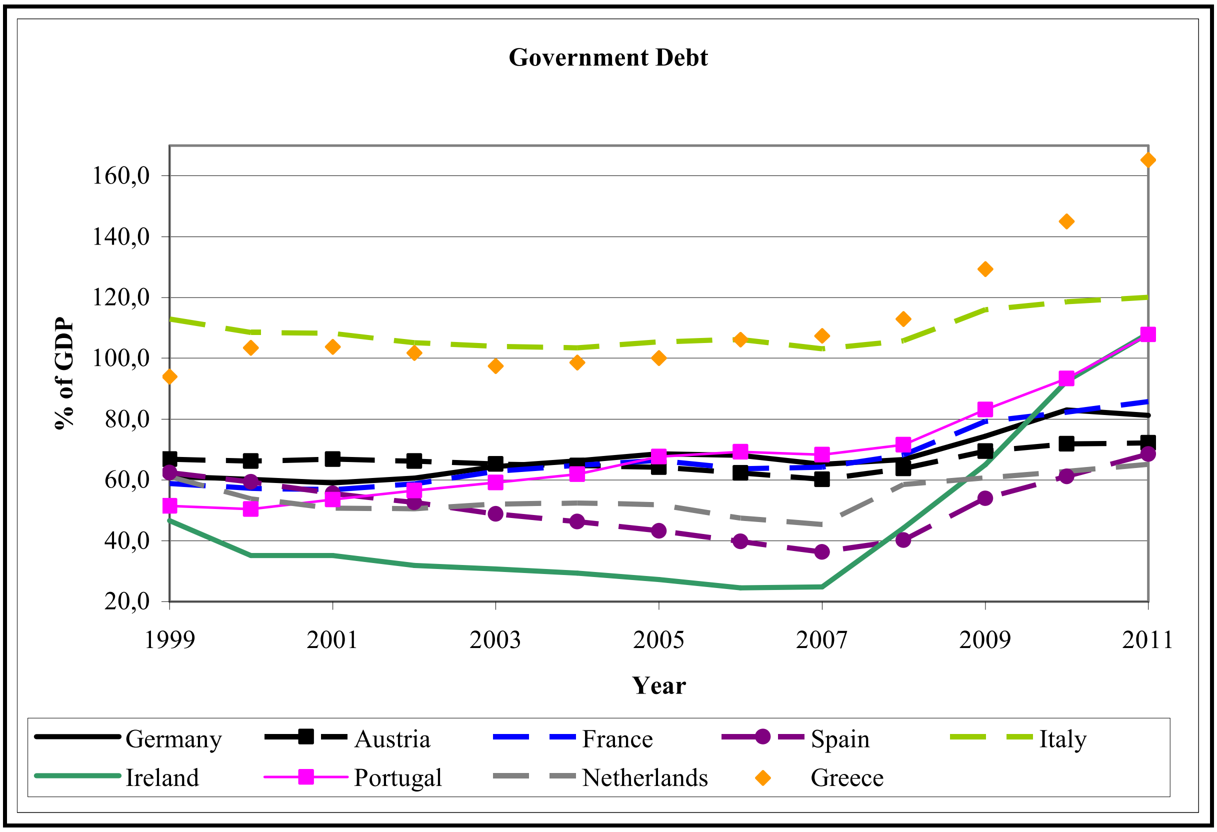


*Fig. 8*: **Public Debt Levels within the EZ (Source: Eurostat)**

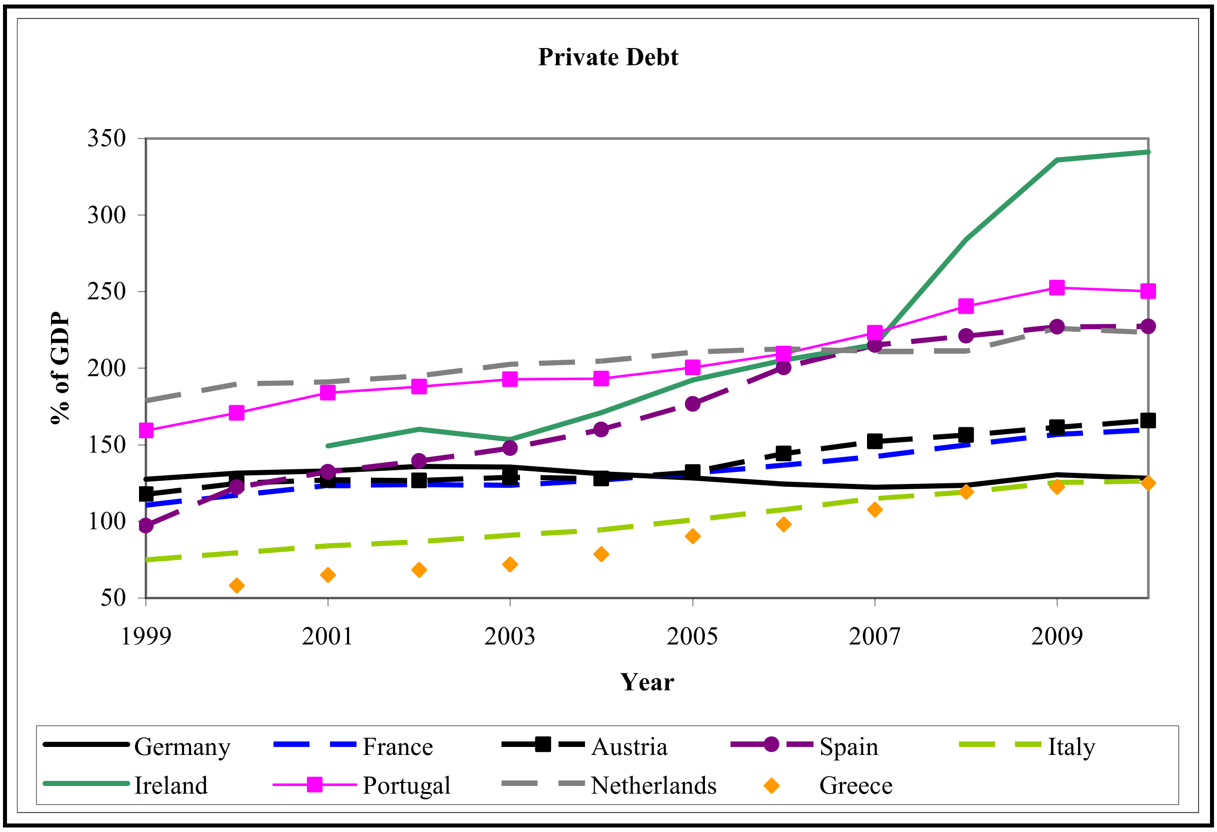


*Fig. 9*: **Private Debt within the EZ (Source: Eurostat)**

Stimulated by low long-term interest rates and accompanying fiscal stimuli and investment booms Spain and Ireland could reduce their public debt levels considerably before the outbreak of the financial crisis 07/08. Even Greece, Italy and Portugal were successful in reducing or stabilizing their public debt levels. Private debt, however, already has increased steadily before and now poses severe problems on the banking sector and hinders private consumption and thus a fast economic turn-around. Moreover, a large part of this debt is foreign held (*Fig. 10*):

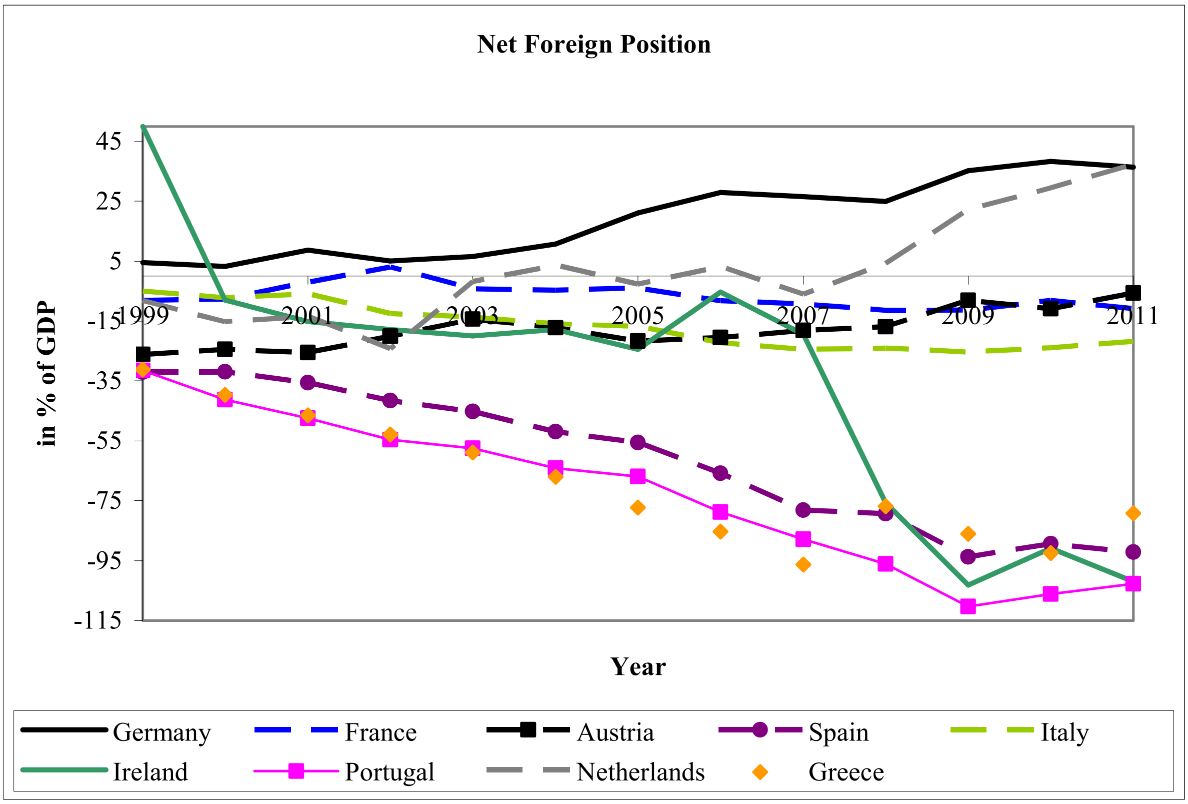


***Fig. 10***: **Net Foreign Position in the EZ (Source: Eurostat)**

Again, the GIPS countries have the highest foreign indebtness, close or even over 100 % of GDP. Whereas the decline of Greece, Portugal and Spain was steadily, Ireland's foreign debt only surged with the outbreak of the financial crisis 07/08.

The development of the net foreign position can be interpreted by current account deficits that were financed by private capital inflows (Mayer et al. [2011]). It becomes apparent that the balanced current account of the EZ as a whole is bought by huge imbalances within. On the one hand there are Germany, Austria and the Netherlands with their strong and competitive export industries and on the other hand there are the GIPS countries (Thompson [2011]). Obviously these imbalances cannot continue indefinitely as "no country can go on for ever covering by new lending a chronic surplus on current account without eventually forcing a default from the other parties." (Keynes [1946]).

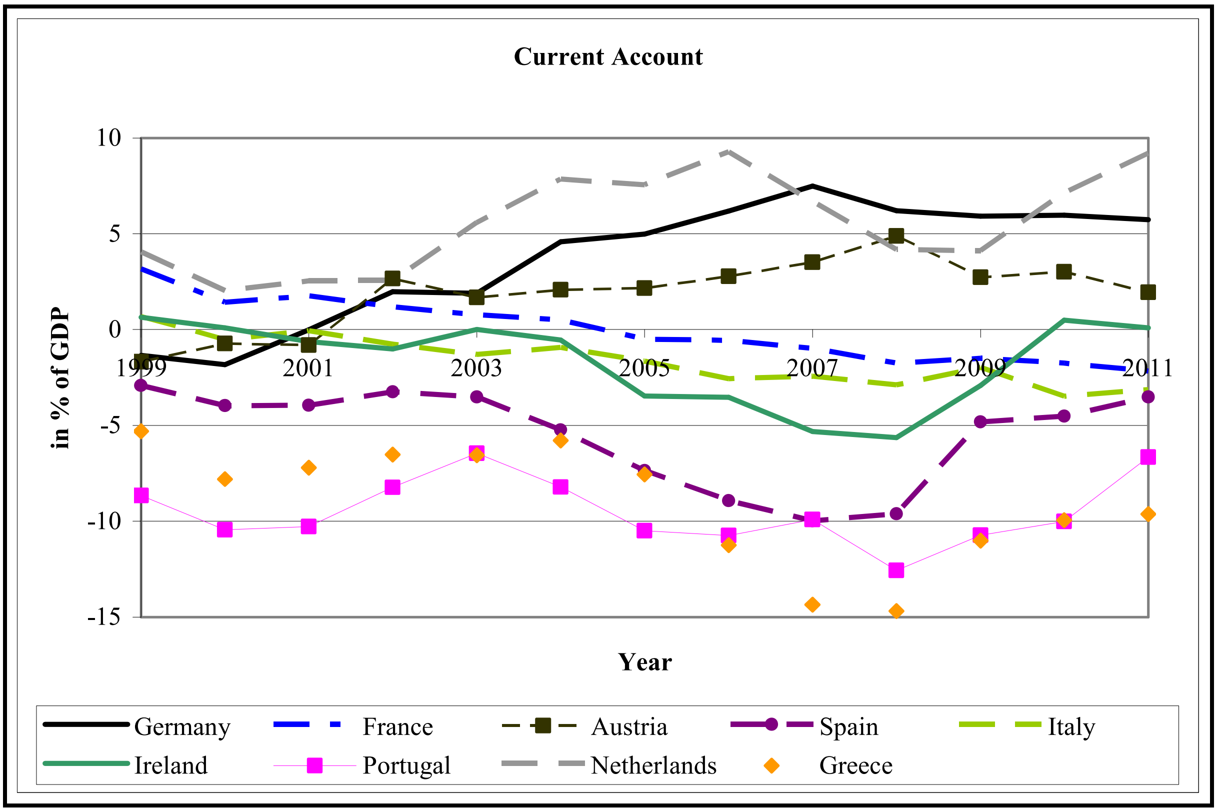


*Fig. 11*: **Current Account Development in the EZ (Source: IMF, OECD)**

As a result the EMU economy is widely imbalanced and in deep economic crisis (Milbradt [2011]). Unfortunately, the economic catch-up process in the GIPS countries before the outbreak of the financial crisis 07/08 was not lasting, but financed to a large part consumption and real estate booms (Neubäumer [2011]). Moreover, the unit labor cost rose considerably and necessary structural reforms were postponed leading to a further loss of competitiveness, sclerotic labor markets and low competition on goods markets (Barkbu et al. [2012]). Although Italy did not experience this unsustainable economic boom it also suffers under the loss of its competitiveness. **(Quelle)**

### 4. The Crisis of the EMU and Stabilization Activities

The common currency, however, is not the reason for the economic imbalances and loss of competitiveness in Southern and peripheral countries. Artificially low interest rates led to the unsustainable booming years and the take-on of large combined and foreign-financed private and public debt levels. The common monetary policy, however, nourished these imbalances by too low interest rates (Neubäumer [2011]). With the outbreak of the financial crisis 07/08 these imbalances became clear, the housing bubbles in Ireland, Portugal and Spain burst and private capital flows reversed their direction and even capital flight occurs leading to an amplification of the economic recession (**Quelle**).

Consequently, stabilization and rescue activities have been decided upon and implemented. As an immediate first-aid the European Central Bank (ECB) established three strands of rescue activities. First, the key interest rate for the main refinancing operations was reduced from 4.25% in July 2008 to 1.00 % since December 2011. Moreover, the minimum rate tender was changed to a fixed rate tender system with full allotment and the minimum requirements for collaterals were reduced substantially. Second, the Securities Markets Program (SMP) was established according to which the ECB bought government bonds of countries under financial stress for 219 billion EUR at the time of this writing. Third, it allowed the build-up of huge TARGET 2 balances. Until the outbreak of the financial crisis

07/08 this balances were of minor magnitude, oscilliated around zero and thus did not play any role. Since then they substituted private capital flows for the financing of current account deficits (Homburg [2011]). At the time of this writing the major creditor countries Germany, Finland, Luxembourg and the Netherlands augmented a combined surplus of 958 billion Euro whereas the major debtor countries' combined deficit amounts to 825 billion Euro. The build-up of TARGET 2 deficits is very favourable as they have no maturity and only carry the key refinancing interest and thus are much cheaper than private capital flows. These deficits can be interpreted as debt financing of current account deficits and capital flight (Meyer et al. [2011]), thus express the economic imbalances and dangerously postpone the necessary adjustment processes (Sinn [2012]). Summarizing, the ECB's policies stabilized the economic framework in times when immediate reactions were necessary and thus prevented a crisis escalation (Neubäumer [2011]). But they cannot go on forever and risk perpetuating economic imbalances and building-up of new sources of financial and real risk. They can be solved by mandatory settlements like in the US Federal Reserve system and market interest on the balances (Sinn [2012]).

The fiscal policy response is established in IMF programs, bilateral credits like in the case of Ireland and Cyprus, the two rescue packages for Greece and the institutionalization of the so-called rescue umbrellas European Financial Stabilisation Mechanism (EFSM), the non-permanent European Financial Stability Facility (EFSF) and finally the permanent European Stability Mechanism (ESM). Under the EFSM the European Union acts as borrower and on-lends the proceeds to the beneficiaries up to 60 billion Euro of which 48.5 billion Euro are meant for the stabilization of Ireland and Portugal. The EFSF is a legal entity on its own and has a lending capacity of 440 billion Euro of which 192 billion Euro are already committed. The ESM as a separate legal entity will succeed the EFSF in 2013 and act as a permanent mechanism to restore economic stability in single member countries hit by asymmetric shocks. The resulting fiscal transfers between member countries are favourable for the functioning of a common currency area (Kenen [1969], Krugman/Obstfeld [2011]). Its importance must even be stressed as the EZ lacks a fiscal unity like the United States where the federal tax and welfare system works as an automatic stabilizer (The Economist [2011]). Moreover, the often stated critic that the rescue umbrellas prevent an efficient capital allocation (Sinn [2011]) must be questioned in light of spill-over effects and contagion risk (Boysen-Hogreve [2011]). In addition the stability of the banking sector in the creditor countries themselves profits from the rescue activities (The Economist [2011b]).

Besides these immediate rescue activities it is necessary to prevent moral hazard strategies. Thus, closer political union and strict rules associated with received fiscal help must be implemented (Klodt [2011]). The requirement of structural economic reforms is necessary and a partial sovereignty loss is inevitable. At the time of this writing the implementation of reforms looks promising in Ireland and Portugal (The European Commission [2012a, 2012b]) but despite legislative progress in Greece the implementation of reforms is retarded and the complete situation is best described as unknown (The European Commission [2012c]).

Moreover, it must not be forgotten that only the financial crisis 07/08 unveiled the economic imbalances in the EMU and excessive lending produced the underlying credit bubbles which are the crisis's root. The banking industry must be stabilized through higher equity ratios, stricter regulation of overtaken risk and eventually a revival of the dual banking system in order to prevent moral hazard strategies. In addition, traditional monetary policy with its focus on the consumer price stability and the accompanying anti-cyclical monetary policy must be rethought as asset price stability plays an important role for overall financial stability. New concepts in form of macroprudential regulation as a supplement to traditional policy might be the right remedy (Hansen et al. [2010]).

## 5. Conclusion

Consequently, it is apparent that the EZ faces great economic challenges that might have been favored but were not caused by the common currency. Even more important the common currency system did stabilize the economic situation and thus must be seen positively (Neubäumer [2011]). Although the exit of single countries out of the EZ are discussed as alternatives it has to be doubted heavily whether this option is the one to be taken in light of the immense immediate economic cost (Cochrane [2011], Deo et al. [2011], The Economist [2011c], Der Spiegel [2012]).

Consequently, the various (immediate) rescue activities have been necessary and correct. Their mid- and long-term success, however, is dependent on the economic reforms implemented within the EZ, the long-term willingness to reduce the debt levels and institutional reforms necessary for preventing moral hazard behaviour of single countries. In the fifth year after the outbreak of the financial crisis 07/08 it is also important to modify the rescue activities, especially the monetary ones, in order to prevent further cementation of the underlying forces of the economic imbalances.

Structural economic reform might lead to higher competitiveness and economic expansion in the coming years. An accompanying overhaul of the financial system could in addition lead to greater financial stability and a reduction of the risk of future financial crisis and thus the EMU's current crisis must be seen as a chance for positive mid- and long-term welfare effects.

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